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(Continued)

§ 1.851–6 Investment companies furnishing capital to development corporations.

(a) *Qualifying requirements.* (1) In the case of a regulated investment company which furnishes capital to development corporations, section 851 (e) provides an exception to the rule relating to the diversification of investments, made applicable to regulated investment companies by section 851 (b) (4) (A). This exception (as provided in paragraph (b) of this section) is available only to registered management investment companies which the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate, not earlier than 60 days before the close of the taxable year of such investment company, to be principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available.

(2) For the purpose of the aforementioned determination and certification, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years before such date it had acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or its predecessor.

(b) *Exception to general rule.* (1) The registered management investment company, which for the taxable year meets the requirements of paragraph (a) of this section, may (subject to the limitations of section 851 (e) (2) and paragraph (c) of this section) in the computation of 50 percent of the value of its assets under section 851 (b) (4) (A) and paragraph (c) (1) of § 1.851–2 for any quarter of such taxable year, include the value of any securities of an issuer (whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer) if at the time of the latest acquisition of any securities of such issuer the basis of all such securities in the hands of the investment company does not exceed 5 percent of the value of the total assets of the investment company at that time. The exception provided by section 851 (e) (1) and this subparagraph is not applicable to the securities of an issuer if the investment company has continuously held any security of such issuer or of any predecessor company (as defined in paragraph (d) of this section) for 10 or more years preceding such quarter of the taxable year. The rule of section 851 (e) (1) with respect to the relationship of the basis of the securities of an issuer to the value of the total assets of the investment company is, in substance, a qualification of the 5-percent limitation in section 851 (b) (4) (A) (ii) and paragraph (c) (1) (iv) of § 1.851–2. All other provisions and requirements of section 851 and §§ 1.851–1 through 1.851–6 are applicable in determining whether such registered management investment company qualifies as a regulated investment company.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) The XYZ Corporation, a regulated investment company, qualified under section 851 (e) as an investment company furnishing capital to development corporations. On June 30, 1954, the XYZ Corporation purchased 1,000 shares of the stock of the A Corporation at a cost of $30,000. On June 30, 1954, the value of the total assets of the XYZ Corporation was $1,000,000. Its investment in the stock of the A Corporation ($30,000) comprised 3 percent of the value of its total assets, and it therefore met the requirements prescribed by section 851 (b) (4) (A) (ii) as modified by section 851 (e) (1).

(ii) On June 30, 1955, the value of the total assets of the XYZ Corporation was $1,500,000 and the 1,000 shares of stock of the A Corporation which the XYZ Corporation owned appreciated in value so that they were then worth $60,000. On that date, the XYZ Investment Company increased its investment in the stock of the A Corporation by the purchase of an additional 500 shares of that stock at a total cost of $30,000. The securities of the A Corporation owned by the

XYZ Corporation had a value of $90,000 (6 percent of the value of the total assets of the XYZ Corporation) which exceeded the limit provided by section 851 (b) (4) (A) (ii). However, the investment of the XYZ Corporation in the A Corporation on June 30, 1955, qualified under section 851 (b) (4) (A) as modified by section 851 (e) (1), since the basis of those securities to the investment company did not exceed 5 percent of the value of its total assets as of June 30, 1955, illustrated as follows:

Basis to the XYZ Corporation of the A Corporation's stock acquired on June 30, 1954	$30,000
Basis of the 500 shares of the A Corporation's stock acquired by the XYZ Corporation on June 30, 1955	30,000
Basis of all stock of A Corporation	60,000

$$\frac{\text{Basis of stock of A Corporation}}{\text{Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition}} = \frac{\$60,000}{\$1,500,000} = 4 \text{ percent}$$

Example (2). The same facts existed as in example (1), except that on June 30, 1955, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 1,000 shares of that stock (instead of 500 shares) at a total cost of $60,000. No part of the investment of the XYZ Corporation in the A Corporation qualified under the 5 percent limitation provided by section 851 (b) (4) (A) as modified by section 851 (e) (1), illustrated as follows:

Basis to the XYZ Corporation of the 1,000 shares of the A Corporation's stock acquired on June 30, 1954	$30,000
Basis of the 1,000 shares of the A Corporation's stock acquired on June 30, 1955	60,000
Total	90,000

$$\frac{\text{Basis of stock of A Corporation}}{\text{Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition}} = \frac{\$90,000}{\$1,500,000} = 6 \text{ percent}$$

Example (3). The same facts existed as in example (2) and on June 30, 1956, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 100 shares of that stock at a total cost of $6,000. On June 30, 1956, the value of the total assets of the XYZ Corporation was $2,000,000 and on that date the investment in the A Corporation qualified under section 851 (b) (4) (A) as modified by section 851 (e) (1) illustrated as follows:

Basis to the XYZ Corporation of investments in the A Corporation's stock:	
1,000 shares acquired June 30, 1954	$30,000
1,000 shares acquired June 30, 1955	60,000
100 shares acquired June 30, 1956	6,000
Total	96,000

$$\frac{\text{Basis of stock of A Corporation}}{\text{Value of XYZ Corporation's total assets at June 30, 1956, time of the latest acquisition}} = \frac{\$96,000}{\$2,000,000} = 4.8 \text{ percent}$$

(c) *Limitation.* Section 851 (e) and this section do not apply in the quarterly computation of 50 percent of the value of the assets of an investment company under subparagraph (A) of section 851 (b) (4) and paragraph (c) (1) of § 1.851–2 for any taxable year if at the close of any quarter of such taxable year more than 25 percent of the value of its total assets (including the 50 percent or more mentioned in such subparagraph (A)) is represented by securities (other than Government securities or the securities of other regulated investment companies) of issuers as to each of which such investment company (1) holds more than 10 percent of the outstanding voting securities of such issuer, and (2) has continuously held any security of such issuer (or any security of a predecessor of such issuer) for 10 or more years preceding such quarter, unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(d) *Definition of predecessor company.* As used in section 851 (e) and this section, the term "predecessor company" means any corporation the basis of whose securities in the hands of the investment company was, under the provisions of section 358 or corresponding provisions of prior law, the same in whole or in part as the basis of any of the securities of the issuer and any corporation with respect to whose securities any of the securities of the issuer were received directly or indirectly by the investment company in a transaction or series of transactions involving nonrecognition of gain or loss in whole or in part. The other terms used in this section have the same meaning as when used in section 851 (b) (4). See paragraph (c) of § 1.851–2 and § 1.851–3.

§ 1.852 Statutory provisions; taxation of regulated investment companies and their shareholders.

SEC. 852. *Taxation of regulated investment companies and their shareholders—*(a) *Requirements applicable to regulated investment companies.* The provisions of this subchapter (other than subsection (c) of this section) shall not be applicable to a regulated investment company for a taxable year unless—

(1) The deduction for dividends paid during the taxable year (as defined in section 561, but without regard to capital gains dividends) equals or exceeds 90 percent of its investment company taxable income for the taxable year (determined without regard to subsection (b) (2) (D)), and

(2) The investment company complies for such year with regulations prescribed by the Secretary or his delegate for the purpose of ascertaining the actual ownership of its outstanding stock.

(b) *Method of taxation of companies and shareholders—*(1) *Imposition of normal tax and surtax on regulated investment companies.* There is hereby imposed for each taxable year upon the investment company taxable income of every regulated investment company a normal tax and surtax computed as provided in section 11, as though the investment company taxable income were the taxable income referred to in section 11. For purposes of computing the normal tax under section 11, the taxable income and the dividends paid deduction of such investment company for the taxable year (computed without regard to capital gains dividends) shall be reduced by the deduction provided by section 242 (relating to partially tax-exempt interest).

(2) *Investment company taxable income.* The investment company taxable income shall be the taxable income of the regulated investment company adjusted as follows:

(A) There shall be excluded the excess, if any, of the net long-term capital gain over the net short-term capital loss.

(B) The net operating loss deduction provided in section 172 shall not be allowed.

(C) The deductions for corporations provided in part VIII (except section 248) in subchapter B (section 241 and following, relating to the deduction for dividends received, etc.) shall not be allowed.

(D) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gains dividends.

(E) The taxable income shall be computed without regard to section 443 (b) (relating to computation of tax on change of annual accounting period).

(3) *Capital gains—*(A) *Imposition of tax.* There is hereby imposed for each taxable year in the case of every regulated investment company a tax of 25 percent of the excess, if any, of the net long-term capital gain over the sum of—

(i) The net short-term capital loss, and

(ii) The deduction for dividends paid (as defined in section 561) determined with reference to capital gains dividends only.

(B) *Treatment of capital gain dividends by shareholders.* A capital gain dividend shall be treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than 6 months.

(C) *Definition of capital gain dividend.* A capital gain dividend means any dividend, or part thereof, which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including capital gains dividends paid after the close of the taxable year described in section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated.

(D) *Treatment by shareholders of undistributed capital gains.* (i) Every shareholder of a regulated investment company at the close of the company's taxable year shall include, in computing his long-term capital gains in his return for his taxable year in which the last day of the company's taxable year falls, such amount as the company shall designate in respect of such shares in a written notice mailed to its shareholders at any time prior to the expiration of 30 days after close of its taxable year, but the amount so includible by any shareholder shall not exceed that part of the amount subjected to tax in subparagraph (A) which he would have received if all of such amount had been distributed as capital gain dividends by the company to the holders of such shares at the close of its taxable year.

(ii) For purposes of this title, every such shareholder shall be deemed to have paid, for his taxable year under clause (i), the tax of 25 percent imposed by subparagraph (A)

vestment company (1) holds more than

on the amounts required by this subparagraph to be included in respect of such shares in computing his long-term capital gains for that year; and such shareholder shall be allowed credit or refund, as the case may be, for the tax so deemed to have been paid by him.

(iii) The adjusted basis of such shares in the hands of the shareholder shall be increased by 75 percent of the amounts required by this subparagraph to be included in computing his long-term capital gains.

(iv) In the event of such designation the tax imposed by subparagraph (A) shall be paid by the regulated investment company within 30 days after close of its taxable year.

(v) The earnings and profits of such regulated investment company, and the earnings and profits of any such shareholder which is a corporation, shall be appropriately adjusted in accordance with regulations prescribed by the Secretary or his delegate.

(c) *Earnings and profits.* The earnings and profits of a regulated investment company for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year. For purposes of this subsection, the term "regulated investment company" includes a domestic corporation which is a regulated investment company determined without regard to the requirements of subsection (a).

[Sec. 852 as amended by sec. 2, Act of July 11, 1956 (Pub. Law 700, 84th Cong., 70 Stat. 530); sec. 101, Technical Amendments Act 1958 (72 Stat. 1674)]

§ 1.852–1 Taxation of regulated investment companies.

(a) *Requirements applicable thereto—*(1) *In general.* Section 852(a) denies the application of the provisions of subchapter M, chapter 1 of the Code (other than section 852(c), relating to earnings and profits), to a regulated investment company for a taxable year beginning after February 28, 1958, unless—

(i) The deduction for dividends paid for such taxable year as defined in section 561 (computed without regard to capital gain dividends) is equal to at least 90 percent of its investment company taxable income for such taxable year (determined without regard to the provisions of section 852(b)(2)(D) and paragraph (d) of § 1.852–3); and

(ii) The company complies for such taxable year with the provisions of § 1.852–6 (relating to records required to be maintained by a regulated investment company).

See section 853(b)(1)(B) and paragraph (a) of § 1.853–2 for amounts to be added to the dividends paid deduction, and section 855 and § 1.855–1, relating to dividends paid after the close of the taxable year.

(2) *Special rule for taxable years of regulated investment companies beginning before March 1, 1958.* The provisions of subchapter M (including section 852(c) are not applicable to a regulated investment company for a taxable year beginning before March 1, 1958, unless such company meets the requirements of section 852(a) and subparagraph (1) (i) and (ii) of this paragraph.

(b) *Failure to qualify.* If a regulated investment company does not meet the requirements of section 852(a) and paragraph (a)(1) (i) and (ii) of this section for the taxable year, it will, even though it may otherwise be classfied as a regulated investment company, be taxed in such year as an ordinary corporation and not as a regulated investment company. In such case, none of the provisions of subchapter M (other than section 852(c) in the case of taxable years beginning after February 28, 1958) will be applicable to it. For the rules relating to the applicability of section 852(c), see § 1.852–5.

§ 1.852–2 Method of taxation of regulated investment companies.

(a) *Imposition of normal tax and surtax.* Section 852(b)(1) imposes a normal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the investment company taxable income, as defined in section 852(b)(2) and § 1.852–3, for each taxable year of a regulated investment company. The tax is imposed as if the investment company taxable income were the taxable income referred to in section 11. In computing the normal tax under section 11, the regulated investment company's taxable income and the dividends paid deduction (computed without regard to the capital gains dividends) shall both be reduced by the deduction for partially tax-exempt interest provided by section 242.

(b) *Taxation of capital gains—*(1) *In general.* Section 852(b)(3)(A) imposes a tax of 25 percent for each taxable year on the excess, if any, of the net long-term capital gain of a regulated investment company (subject to tax under subchapter M, chapter 1 of the Code) over the sum of its net short-term capital loss and its deduction for dividends paid (as defined in section 561) determined with reference to capital gain dividends only. For the definition of capital gain dividend paid by a regulated investment company, see section 852(b)(3)(C) and paragraph (c) of § 1.852–4. See section 855 and § 1.855–1, relating to dividends paid after the close of the taxable year.

(2) *Undistributed capital gains—*(i) *In general.* A regulated investment company (subject to tax under subchapter M) may, for taxable years beginning after December 31, 1956, designate under section 852(b)(3)(D) an amount of undistributed capital gains to each shareholder of the company. For the definition of the term "undistributed capital gains" and for the treatment of such amounts by a shareholder, see paragraph (b)(2) of § 1.852–4. For the rules relating to the method of making such designation, the returns to be filed, and the payment of the tax in such cases, see paragraph (a) of § 1.852–9.

(ii) *Effect on earnings and profits of a regulated investment company.* If a regulated investment company designates an amount as undistributed capital gains for a taxable year, the earnings and profits of such regulated investment company for such taxable year shall be reduced by the total amount of the undistributed capital gains so designated and its capital account shall be increased by 75 percent of such amount. The earnings and profits of a regulated investment company shall not be reduced by the amount of tax which is imposed by section 852(b)(3)(A) on an amount designated as undistributed capital gains and which is paid by the corporation but deemed paid by the shareholder.

§ 1.852–3 Investment company taxable income.

Section 852(b)(2) requires certain adjustments to be made to convert taxable income of the investment company to investment company taxable income, as follows:

(a) The excess, if any, of the net long-term capital gain over the net short-term capital loss shall be excluded;

(b) The net operating loss deduction provided in section 172 shall not be allowed;

(c) The special deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code, shall not be allowed. Those not allowed are the deduction for partially tax-exempt interest provided by section 242, the deductions for dividends received provided by sections 243, 244, and 245, and the deduction for certain dividends paid provided by section 247. However, the deduction provided by section 248 (relating to organizational expenditures), otherwise allowable in computing taxable income, shall likewise be allowed in computing the investment company taxable income. See section 852(b)(1) and paragraph (a) of § 1.852–2 for treatment of the deduction for partially tax-exempt interest (provided by section 242) for purposes of computing the normal tax under section 11;

(d) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gains dividends (as defined in section 852 (b) (3) (C) and paragraph (c) of § 1.852–4; and

(e) The taxable income shall be computed without regard to section 443 (b). Thus, the taxable income for a period of less than 12 months shall not be placed on an annual basis even though such short taxable year results from a change of accounting period.

§ 1.852–4 Method of taxation of shareholders of regulated investment companies.

(a) *Ordinary income.* (1) Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a regulated investment company shall include such dividends in gross income for the taxable year in which they are received.

(2) See section 853 (b) (2) and (c) and paragraph (b) of § 1.853–2 and § 1.853–3 for the treatment by shareholders of dividends received from a regulated investment company which has made an election under section 853(a) with respect to the foreign tax credit. See section 854 and §§ 1.854–1 through 1.854–3 for limitations applicable to dividends received from regulated investment companies for the purpose of the credit under section 34, the exclusion from gross income under section 116, and the deduction under section 243. See section 855 (b) and (d)

and paragraphs (c) and (f) of § 1.855–1 for treatment by shareholders of dividends paid by a regulated investment company after the close of the taxable year in the case of an election under section 855 (a).

(b) *Capital gains*—(1) *In general.* Under section 852(b)(3)(B), shareholders of a regulated investment company who receive capital gain dividends (as defined in paragraph (c) of this section), in respect of the capital gains of an investment company for a taxable year for which it is taxable under subchapter M, chapter 1 of the Code, as a regulated investment company, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 6 months and realized in the taxable year of the shareholder in which the dividend was received.

(2) *Undistributed capital gains.* (i) A person who is a shareholder of a regulated investment company at the close of a taxable year of such company for which it is taxable under subchapter M shall include in his gross income as a gain from the sale or exchange of a capital asset held for more than 6 months any amount of undistributed capital gains. The term "undistributed capital gains" means the amount designated as undistributed capital gains in accordance with paragraph (a) of § 1.852–9, but such amount shall not exceed the shareholder's proportionate part of the amount subject to tax under section 852 (b) (3) (A). Such amount shall be included in gross income for the taxable year of the shareholder in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. For certain administrative provisions relating to undistributed capital gains, see § 1.852–9.

(ii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852 (b)(3)(D) and subdivision (i) of this subparagraph shall be deemed to have paid a tax equal to 25 percent of such amount for his taxable year for which such amount is so includible. Such shareholder is entitled to a credit or refund of the tax so deemed paid in accordance with the rules provided in paragraph (c)(2) of § 1.852–9.

(iii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852 (b)(3)(D) and subdivision (i) of this subparagraph shall increase the adjusted basis of the shares of stock with respect to which such amount is so includible by 75 percent of such amount.

(3) *Partners and partnerships.* If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a partnership, such amount shall be included in the gross income of the partnership for the taxable year of the partnership in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. The amount so includible by the partnership shall be taken into account by the partners as distributive shares of the partnership gains and losses from sales or exchanges of capital assets held for more than 6 months pursuant to section 702(a)(2) and paragraph (a)(2) of § 1.702–1. The tax with respect to the undistributed capital gains is deemed paid by the partnership (under section 852(b)(3)(D)(ii) and subparagraph (2)(ii) of this paragraph), and the credit or refund of such tax shall be taken into account by the partners in accordance with section 702(a)(8) and paragraph (a)(8)(ii) of § 1.702–1 and paragraph (c)(2) of § 1.852–9. In accordance with section 705(a), the partners shall increase the basis of their partnership interests under section 705(a)(1) by the distributive shares of such gains, and shall decrease the basis of their partnership interests by the distributive shares of the amount of the tax under section 705(a)(2)(B) (relating to certain nondeductible expenditures) and paragraph (a)(3) of § 1.705–1.

(4) *Nonresident alien individuals.* If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a nonresident alien individual, such shareholder shall be treated, for purposes of section 871 and the regulations thereunder, as having realized a long-term capital gain in such amount on the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated.

(5) *Effect on earnings and profits of corporate shareholders of a regulated investment company.* If a shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a corporation, such corporation, in computing its earnings and profits for the taxable year for which such amount is so includible, shall treat such amount as if it had actually been received and the taxes paid shall include any amount of tax liability satisfied by a credit under section 852(b)(3)(D) and subparagraph (2) of this paragraph.

(c) *Definition of capital gain dividend.* A capital gain dividend, as defined in section 852(b)(3)(C), is any dividend or part thereof which is designated by a regulated investment company as a capital gain dividend in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year. If the aggregate amount so designated with respect to the taxable year (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated. For example, a regulated investment company making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1955, that of a distribution of $500,000 made December 15, 1955, $200,000 constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, and that such excess was $100,000 instead of $200,000. In such case each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.

§ 1.852–5 Earnings and profits of a regulated investment company.

(a) Any regulated investment company, whether or not such company meets the requirements of section 852(a) and paragraph (a)(1) (i) and (ii) of § 1.852–1, shall apply paragraph (b) of this section in computing its earnings and profits for a taxable year beginning after February 28, 1958. However, for a taxable year of a regulated investment company beginning before March 1, 1958, paragraph (b) of this section shall apply only if the regulated investment company meets the requirements of section 852(a) and paragraph (a)(1) (i) and (ii) of § 1.852–1.

(b) In the determination of the earnings and profits of a regulated investment company, section 852(c) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a corporation would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a regulated investment company would be $500,000. If the regulated investment company had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, $500,000, the corporation would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and would begin such year with its paid-in capital reduced by $100,000, an amount equal to the excess of the $500,000 distributed over the $400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year.

§ 1.852–6 Records to be kept for purpose of determining whether a corporation claiming to be a regulated investment company is a personal holding company.

(a) Every regulated investment company shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from the shareholders. The actual owner of stock includes the person who is required to include in gross income in his return the dividends received on the stock. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) For the purpose of determining whether a domestic corporation claiming to be a regulated investment company is a personal holding company as defined in section 542, the permanent records of the company shall show the maximum number of shares of the corporation (including the number and face value of securities convertible into stock of the corporation) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the corporation's taxable year, as provided in section 544.

(c) Statements setting forth the information (required by paragraph (b) of this section) shall be demanded not later than 30 days after the close of the corporation's taxable year as follows:

(1) In the case of a corporation having 2,000 or more record owners of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a corporation having less than 2,000 and more than 200 record owners of its stock, on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a corporation having 200 or less record owners of its stock, on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

When making demand for the written statements required of each shareholder by this paragraph, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by § 1.852–7 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with a company's demand shall be maintained as a part of its record required by this section. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by this section shall be taxable as an ordinary corporation and not as a regulated investment company.

§ 1.852–7 Additional information required in returns of shareholders.

Any person who fails or refuses to comply with the demand of a regulated investment company for the written statements which § 1.852–6 requires the company to demand from its shareholders shall submit as a part of his income tax return a statement showing, to the best of his knowledge and belief—

(a) The number of shares actually owned by him at any and all times during the period for which the return is filed in any company claiming to be a regulated investment company;

(b) The dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(c) The dates of disposition of any such stock during such period and the names and addresses of the transferees thereof;

(d) The names and addresses of the members of his family (as defined in section 544 (a) (2)); the names and addresses of his partners, if any, in any partnership; and the maximum number of shares, if any, actually owned by each in any corporation claiming to be a regulated investment company, at any time during the last half of the taxable year of such company;

(e) The names and addresses of any corporation, partnership, association, or trust in which he had a beneficial interest to the extent of at least 10 percent at any time during the period for which such return is made, and the number of shares of any corporation claiming to be a regulated investment company actually owned by each;

(f) The maximum number of shares (including the number and face value of securities convertible into stock of the corporation) in any domestic corporation claiming to be a regulated investment company to be considered as constructively owned by such individual at any time during the last half of the corporation's taxable year, as provided in section 544 and the regulations thereunder; and

(g) The amount and date of receipt of each dividend received during such period from every corporation claiming to be a regulated investment company.

§ 1.852–8 Information returns.

Nothing in §§ 1.852–6 and 1.852–7 shall be construed to relieve regulated investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under the provisions of subchapter A, chapter 61 of the Code.

§ 1.852–9 Special procedural requirements applicable to designation under section 852(b)(3)(D).

(a) *Regulated investment company—*(1) *Notice to shareholder.* A designation of undistributed capital gains under section 852(b)(3)(D) and paragraph (b)(2)(i) of § 1.852–2 shall be made by notice on Form 2439 mailed by the regulated investment company to each person who is a shareholder of the company at the close of the company's taxable year. The notice on Form 2439 shall show the name and address of the regulated investment company, the taxable year of the company for which the designation is made, the name and address of the shareholder, the amount designated by the company for inclusion by the shareholder in computing his long-term capital gains, and the tax paid with respect thereto by the company, which tax is deemed to have been paid by the shareholder. Form 2439 shall be prepared in triplicate, and copies B and C of the form shall be mailed to the shareholder on or before the 30th day following the close of the company's taxable year. Copy A of each Form 2439 must be associated with the undistributed capital gains tax return of the company (Form 2438), as provided in subparagraph (2) of this paragraph.

(2) *Return of undistributed capital gains tax—*(i) *Form 2438.* Every regulated investment company which designates undistributed capital gains for any taxable year beginning after December 31, 1956, in accordance with subparagraph (1) of this paragraph, shall file for such taxable year an undistributed capital gains tax return on Form 2438 including on such return the total of its undistributed capital gains so designated and the tax with respect thereto. The return on Form 2438 shall be prepared in duplicate and shall set forth fully and clearly the information required to be included therein. The original of Form 2438 shall be filed on or before the 30th day after the close of the company's taxable year with the district director with whom the company is required to file its income tax return on Form 1120 for such year. The duplicate copy of Form 2438 for the taxable year shall be attached to and filed with the income tax return of the company on Form 1120 for such taxable year.

(ii) *Copies A of Form 2439.* There shall be submitted with the company's return on Form 2438 all copies A of Form 2439 furnished by the company to its shareholders in accordance with subparagraph (1) of this paragraph. The copies A of Form 2439 shall be accompanied by lists (preferably in the form of adding machine tapes) of the amounts of undistributed capital gains and of the tax paid with respect thereto shown on such forms. The totals of the listed amounts of undistributed capital gains and of tax paid with respect thereto must agree with the corresponding entries in the return on Form 2438.

(3) *Payment of tax.* The tax required to be returned on Form 2438 shall be paid by the regulated investment company on or before the 30th day after the close of the company's taxable year to the district director with whom the return on Form 2438 is required to be filed.

(b) *Shareholder of record not actual owner—*(1) *Notice to actual owner.* In any case in which a notice on Form 2439 is mailed pursuant to paragraph (a)(1) of this section by a regulated investment company to a shareholder of record who is a nominee of the actual owner or owners of the shares of stock to which the notice relates, the nominee shall furnish to each such actual owner notice of the owner's proportionate share of the amounts of undistributed capital gains and tax with respect thereto, shown on the Form 2439 received by the nominee from the regulated investment company. The nominee's notice to the actual owner shall be prepared in triplicate on Form

2439 and shall contain the information prescribed in paragraph (a)(1) of this section, except that the name and address of the nominee, identified as such, shall be entered on the form in addition to, and in the space provided for, the name and address of the regulated investment company, and the amounts of undistributed capital gains and tax with respect thereto entered on the form shall be the actual owner's proportionate share of the corresponding items shown on the nominee's notice from the regulated investment company. Copies B and C of the Form 2439 prepared by the nominee shall be mailed to the actual owner on or before the 60th day (120th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year.

(2) *Transmittal of Form 2439.* The nominee shall enter the word "Nominee" in the upper right hand corner of copy B of the notice on Form 2439 received by him from the regulated investment company, and on or before the 60th day (120th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year shall transmit such copy B, together with all copies A of Form 2439 prepared by him pursuant to subparagraph (1) of this paragraph, to the internal revenue officer with whom his income tax return is required to be filed.

(c) *Shareholders*—(1) *Return requirements.* The copy B of the Form 2439 furnished to a shareholder by the regulated investment company or by a nominee, as provided in paragraph (a) or (b), respectively, of this section, shall be attached to the return of income made by the shareholder for his taxable year in which the amount of undistributed capital gains is includible in gross income, as provided in paragraph (b)(2) of § 1.852–4.

(2) *Credit or refund*—(i) *In general.* The amount of the tax paid by the regulated investment company with respect to the undistributed capital gains required under section 852(b)(3)(D) and paragraph (b)(2) of § 1.852–4 to be included by a shareholder in his computation of long-term capital gains for any taxable year is deemed paid by such shareholder under section 852(b)(3)(D)(ii) and such payment constitutes, for purposes of section 6513(a) (relating to time tax considered paid), an advance payment in like amount of the tax imposed under chapter 1 of the Code for such taxable year. In the case of an overpayment of tax within the meaning of section 6401, see section 6402 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration) for rules applicable to the treatment of an overpayment of tax and section 6511 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration) with respect to the limitations applicable to the credit or refund of an overpayment of tax.

(ii) *Form to be used.* Claim for refund or credit of the tax deemed to have been paid by a shareholder with respect to an amount of undistributed capital gains shall be made on the shareholder's income tax return for the taxable year in which such amount of undistributed capital gains is includible in gross income. In the case of a shareholder which is a partnership, claim shall be made by the partners on their income tax returns for refund or credit of their distributive shares of the tax deemed to have been paid by the partnership. In the case of a shareholder who is a nonresident alien individual or a nonresident foreign corporation claiming credit or refund of the tax deemed paid by such shareholder on undistributed capital gains, see section 6012 and the regulations thereunder. In the case of a shareholder which is exempt from tax under section 501(a) and to which section 511 does not apply for the taxable year, claim for refund of the tax deemed to have been paid by such shareholder on an amount of undistributed capital gains for such year shall be made on Form 843 and copy B of Form 2439 furnished to such shareholder shall be attached to its claim. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see § 301.6402–2 of this chapter (Regulations on Procedure and Administration), relating to claims for credit or refund, and § 301.6402–3 of such regulations, relating to special rules applicable to income tax.

(d) *Penalties.* For criminal penalties for willful failure to file a return, supply information, or pay tax, and for filing a false or fraudulent return, statement, or other document, see sections 7203, 7206, and 7207.

§ 1.853 Statutory provisions; foreign tax credit allowed to shareholders.

SEC. 853. *Foreign tax credit allowed to shareholders*—(a) *General rule.* A regulated investment company—

(1) More than 50 percent of the value (as defined in section 851 (c) (4)) of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations, and

(2) Which meets the requirements of section 852 (a) for the taxable year,

may, for such taxable year, elect the application of this section with respect to income, war profits, and excess profits taxes described in section 901 (b) (1), which are paid by the investment company during such taxable year to foreign countries and possessions of the United States.

(b) *Effect of election.* If the election provided in subsection (a) is effective for a taxable year—

(1) The regulated investment company—

(A) Shall not, with respect to such taxable year, be allowed a deduction under section 164 (a) or a credit under section 901 for taxes to which subsection (a) is applicable, and

(B) Shall be allowed as an addition to the dividends paid deduction for such taxable year the amount of such taxes;

(2) Each shareholder of such investment company shall—

(A) Include in gross income and treat as paid by him his proportionate share of such taxes, and

(B) Treat as gross income from sources within the respective foreign countries and possessions of the United States, for purposes of applying subpart A of part III of subchapter N, the sum of his proportionate share of such taxes and the portion of any dividend paid by such investment company which represents income derived from sources within foreign countries or possessions of the United States.

(c) *Notice to shareholders.* The amounts to be treated by the shareholder, for purposes of subsection (b) (2), as his proportionate share of—

(1) Taxes paid to any foreign country or possession of the United States, and

(2) Gross income derived from sources within any foreign country or possession of the United States,

shall not exceed the amounts so designated by the company in a written notice mailed to its shareholders not later than 30 days after the close of its taxable year.

(d) *Manner of making election and notifying shareholders.* The election provided in subsection (a) and the notice to shareholders required by subsection (c) shall be made in such manner as the Secretary or his delegate may prescribe by regulations.

(e) *Cross references.* (1) For treatment by shareholders of taxes paid to foreign countries and possessions of the United States, see section 164 (a) and section 901.

(2) For definition of foreign corporation, see section 7701 (a) (5).

§ 1.853–1 Foreign tax credit allowed to shareholders.

(a) *In general.* Under section 853, a regulated investment company, meeting the requirements set forth in section 853(a) and paragraph (b) of this section, may make an election with respect to the income, war-profits, and excess profits taxes described in section 901(b) (1) which it pays to foreign countries or possessions of the United States during the taxable year, including such taxes as are deemed paid by it under the provisions of any income tax convention to which the United States is a party. If an election is made, the shareholders of the regulated investment company shall apply their proportionate share of such foreign taxes paid, or deemed to have been paid by it pursuant to any income tax convention, as either a credit (under section 901) or as a deduction (under section 164 (a)) as provided by section 853 (b) (2) and paragraph (b) of § 1.853–2. The election is not applicable with respect to taxes deemed to have been paid under section 902 (relating to the credit allowed to corporate stockholders of a foreign corporation for taxes paid by such foreign corporation).

(b) *Requirements.* To qualify for the election provided in section 853 (a), a regulated investment company (1) must have more than 50 percent of the value of its total assets, at the close of the taxable year for which the election is made, invested in stocks and securities of foreign corporations, and (2) must also, for that year, comply with the requirements prescribed in section 852 (a) and paragraph (a) of § 1.852–1. The term "value", for purposes of the first requirement, is defined in section 851 (c) (4). For the definition of foreign corporation, see section 7701 (a).

§ 1.853–2 Effect of election.

(a) *Regulated investment company.* A regulated investment company making a valid election with respect to a taxable year under the provisions of section 853 (a) is, for such year, denied both the deduction for foreign taxes provided by section 164 (a) and the credit for foreign taxes provided by section 901 with re-

spect to all income, war-profits, and excess profits taxes (described in section 901 (b) (1)) which it has paid to any foreign country or possession of the United States. See section 853 (b) (1) (A). However, under section 853 (b) (1) (B), the regulated investment company is permitted to add the amount of such foreign taxes paid to its dividends paid deduction for that taxable year. See paragraph (a) of § 1.852–1.

(b) *Shareholder.* Under section 853 (b) (2), a shareholder of an investment company, which has made the election under section 853, is, in effect, placed in the same position as a person directly owning stock in foreign corporations, in that he must include in his gross income (in addition to taxable dividends actually received) his proportionate share of such foreign taxes paid and must treat such amount as foreign taxes paid by him for the purposes of the deduction under section 164 (a) and the credit under section 901. For such purposes he must treat as gross income from a foreign country or possession of the United States (1) his proportionate share of the taxes paid by the regulated investment company to such foreign country or possession and (2) the portion of any dividend paid by the investment company which represents income derived from such sources.

(c) *Dividends paid after the close of the taxable year.* For additional rules applicable to certain distributions made after the close of the taxable year which may be designated as income received from sources within and taxes paid to foreign countries or possessions of the United States, see section 855 (d) and paragraph (f) of § 1.855–1.

(d) *Example.* This section may be illustrated as follows:

(1) The X Corporation, a regulated investment company, has total assets, at the close of the taxable year, of $10 million invested as follows:

Domestic corporations		$4,000,000
Foreign corporations in:		
Country A	$3,500,000	
Country B	2,500,000	6,000,000
Total assets		10,000,000

(2) The dividend income of X Corporation is received from the following sources:

Domestic corporations		$300,000
Foreign corporations:		
Country A	$250,000	
Country B	250,000	500,000
Total dividend income		800,000
Operation and management expenses		80,000
Net dividend income		720,000
Taxes withheld by Country A on dividends of $250,000 at a rate of 10 percent	$25,000	
Taxes withheld by Country B on dividends of $250,000 at a rate of 20 percent	50,000	
Total foreign taxes withheld		75,000
Income available for distribution		645,000

(3) X Corporation has 250,000 shares of common stock outstanding and distributes the entire $645,000 as a dividend of $2.58 per share of stock.

(4) The X Corporation meets the 50 percent requirement of section 851 (b) (4) and the requirements of section 852 (a). It notifies each shareholder by mail, within the time prescribed by section 853 (c), that by reason of the election they are to treat as foreign taxes paid $0.30 per share of stock ($75,000 of foreign taxes paid, divided by the 250,000 shares of stock outstanding), of which $0.20 represents taxes paid to Country B and $0.10 taxes paid to Country A. The shareholders must report as income $2.88 per share ($2.58 of dividends actually received plus the $0.30 representing foreign taxes paid). Of the $2.88 per share, $1.80 per share ($450,000 (which represents such part of the net dividend income of $720,000 as the foreign dividend income of $500,000 bears to the total dividend income of $800,000) divided by 250,000 shares) is to be considered as received from foreign sources. Ninety cents is to be considered as received from Country A, and ninety cents from Country B.

§ 1.853–3 Notice to shareholders.

If a regulated investment company makes an election under section 853(a), in the manner provided in § 1.853–4, the investment company is required, under section 853(c), to furnish its shareholders with a written notice mailed not later than 30 days after the close of its taxable year. The notice must designate the shareholder's portion of foreign taxes paid to each such country or possession and the portion of the dividend which represents income derived from sources within each such country or possession. For purposes of section 853(b)(2) and paragraph (b) of § 1.853–2, the amount that a shareholder may treat as his proportionate share of foreign taxes paid and the amount to be included as gross income derived from any foreign country or possession of the United States shall not exceed the amounts so designated by the company in such written notice. If, however, the amount designated by the company in the notice exceeds the shareholder's proper proportionate share of foreign taxes or gross income from sources within any foreign country or possession, the shareholder is limited to the amount correctly ascertained.

§ 1.853–4 Manner of making election.

(a) *General rule.* A regulated investment company, to make a valid election under section 853, must—

(1) File with Form 1099 and Form 1096 a statement as part of its return which sets forth the following information:

(i) The total amount of income received from sources within foreign countries and possessions of the United States;

(ii) The total amount of income, war-profits, or excess profits taxes (described in section 901 (b) (1)) paid, or deemed to have been paid under the provisions of any treaty to which the United States is a party, to such foreign countries or possessions;

(iii) The date, form, and contents of the notice to its shareholders;

(iv) The proportionate share of such taxes paid during the taxable year and foreign income received during such year attributable to one share of stock of the regulated investment company;

and

(2) File as part of its return for the taxable year a Form 1118 modified so that it becomes a statement in support of the election made by a regulated investment company for taxes paid to a foreign country or a possession of the United States.

(b) *Irrevocability of the election.* The election is applicable only with respect to taxable years subject to the Code, shall be made with respect to all such foreign taxes, and must be made not later than the time prescribed for filing the return (including extensions thereof). Such election, if made, shall be irrevocable with respect to the dividend (or portion thereof), and the foreign taxes paid with respect thereto, to which the election applies.

§ 1.854 Statutory provisions; limitations applicable to dividends received from regulated investment company.

SEC. 854. *Limitations applicable to dividends received from regulated investment company*—(a) *Capital gain dividend.* For purposes of section 34 (a) (relating to credit for dividends received by individuals), section 116 (relating to an exclusion for dividends received by individuals), and section 243 (relating to deductions for dividends received by corporations), a capital gain dividend (as defined in section 852 (b) (3)) received from a regulated investment company shall not be considered as a dividend.

(b) *Other dividends*—(1) *General rule.* In the case of a dividend received from a regulated investment company (other than a dividend to which subsection (a) applies)—

(A) If such investment company meets the requirements of section 852 (a) for the taxable year during which it paid such dividend; and

(B) The aggregate dividends received by such company during such taxable year are less than 75 percent of its gross income,

then, in computing the credit under section 34 (a), the exclusion under section 116, and the deduction under section 243, there shall be taken into account only that portion of

the dividend which bears the same ratio to the amount of such dividend as the aggregate dividends received by such company during such taxable year bear to its gross income for such taxable year.

(2) *Notice to shareholders.* The amount of any distribution by a regulated investment company which may be taken into account as a dividend for purposes of the credit under section 34, the exclusion under section 116, and the deduction under section 243 shall not exceed the amount so designated by the company in a written notice to its shareholders mailed not later than 30 days after the close of its taxable year.

(3) *Definitions.* For purposes of this subsection—

(A) The term "gross income" does not include gain from the sale or other disposition of stock or securities.

(B) The term "aggregate dividends received" includes only dividends received from domestic corporations other than dividends described in section 116 (b) (relating to dividends excluded from gross income). In determining the amount of any dividend for purposes of this subparagraph, the rules provided in section 116 (c) (relating to certain distributions) shall apply.

§ 1.854–1 Limitations applicable to dividends received from regulated investment company.

(a) *In general.* Section 854 provides special limitations applicable to dividends received from a regulated investment company for purposes of the credit under section 34 and the exclusion under section 116 for dividends received by individuals, and the deduction under section 243 for dividends received by corporations.

(b) *Capital gain dividend.* Under the provisions of section 854 (a) a capital gain dividend as defined in section 852 (b) (3) and paragraph (c) of § 1.852–4 shall not be considered a dividend for purposes of the credit under section 34, the exclusion under section 116, or the deduction under section 243.

(c) *Rule for dividends other than capital gain dividends.* (1) Section 854 (b) (1) limits the amount that may be treated as a dividend (other than a capital gain dividend) by the shareholder of a regulated investment company, for the purposes of the credit, exclusion, and deduction specified in paragraph (b) of this section, where the investment company receives substantial amounts of income (such as interest, etc.) from sources other than dividends from domestic corporations, which dividends qualify for the exclusion under section 116.

(2) Where the "aggregate dividends received" (as defined in section 854 (b) (3) (B) and paragraph (b) of § 1.854–3) during the taxable year by a regulated investment company (which meets the requirements of section 852 (a) and paragraph (a) of § 1.852–1 for the taxable year during which it paid such dividend) are less than 75 percent of its gross income for such taxable year, (as defined in section 854 (b) (3) (A) and paragraph (a) of § 1.854–3), only that portion of the dividend paid by the regulated investment company which bears the same ratio to the amount of such dividend paid as the aggregate dividends received by the regulated investment company, during the taxable year, bears to its gross income for such taxable year (computed without regard to gains from the sale or other disposition of stocks or securities) may be treated as a dividend for purposes of such credit, exclusion, and deduction.

(3) Subparagraph (2) of this paragraph may be illustrated by the following example:

Example. The XYZ regulated investment company meets the requirements of section 852 (a) for the taxable year and has received income from the following sources:

Capital gains (from the sale of stock or securities)	$100,000
Dividends (from domestic sources other than dividends described in section 116 (b))	70,000
Dividend (from foreign corporations)	5,000
Interest	25,000
Total	200,000
Expenses	20,000
Taxable income	180,000

The regulated investment company decides to distribute the entire $180,000. It distributes a capital gain dividend of $100,000 and a dividend of ordinary income of $80,000. The aggregate dividends received by the regulated investment company from domestic corporations ($70,000) is less than 75 percent of its gross income ($100,000) computed without regard to capital gains from sales of securities. Therefore, an apportionment is required. Since $70,000 is 70 percent of $100,000, out of every $1 dividend of ordinary income paid by the regulated investment company only 70 cents would be available for the credit, exclusion, or deduction referred to in section 854 (b) (1). The capital gains dividend and the dividend received from foreign corporations are excluded from the computation.

(d) *Dividends received from a regulated investment company during taxable years of shareholders ending after July 31, 1954, and subject to the Internal Revenue Code of 1939.* For the application of section 854 to taxable years of shareholders of a regulated investment company ending after July 31, 1954, and subject to the Internal Revenue Code of 1939, see § 1.34–5 and § 1.116–2.

§ 1.854–2 Notice to shareholders.

Section 854(b)(2) provides that the amount that a shareholder may treat as a dividend for purposes of the credit for dividends received by individuals provided by section 34 (a), the exclusion for dividends received by individuals provided by section 116, and the deduction for dividends received by corporations provided by section 243, shall not exceed the amount so designated by the company in a written notice to its shareholders mailed not later than 30 days after the close of the company's taxable year. If, however, the amount so designated by the company in the notice exceeds the amount which may be treated by the shareholder as a dividend for such purposes, the shareholder is limited to the amount as correctly ascertained under section 854 (b) (1) and paragraph (c) of § 1.854–1.

§ 1.854–3 Definitions.

(a) For the purpose of computing the limitation prescribed by section 854(b) (1) (B) and paragraph (c) of § 1.854–1, the term "gross income" does not include gain from the sale or other disposition of stock or securities. However, capital gains arising from the sale or other disposition of capital assets, other than stock or securities, shall not be excluded from gross income for this purpose.

(b) The term "aggregate dividends received" includes only dividends received from domestic corporations other than dividends described in section 116 (b) (relating to dividends not eligible for exclusion from gross income). Accordingly, dividends received from foreign corporations will not be included in the computation of "aggregate dividends received". In determining the amount of any dividend for purposes of this section, the rules provided in section 116 (c) (relating to certain distributions) shall apply.

§ 1.855 Statutory provisions; dividends paid by regulated investment company after close of taxable year.

SEC. 855. *Dividends paid by regulated investment company after close of taxable year*—(a) *General rule.* For purposes of this chapter, if a regulated investment company—

(1) Declares a dividend prior to the time prescribed by law for the filing of its return for a taxable year (including the period of any extension of time granted for filing such return), and

(2) Distributes the amount of such dividend to shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration,

the amount so declared and distributed shall, to the extent the company elects in such return in accordance with regulations prescribed by the Secretary or his delegate, be considered as having been paid during such taxable year, except as provided in subsections (b), (c) and (d).

(b) *Receipt by shareholder.* Amounts to which subsection (a) is applicable shall be treated as received by the shareholder in the taxable year in which the distribution is made.

(c) *Notice to shareholders.* In the case of amounts to which subsection (a) is applicable, any notice to shareholders required under this subchapter with respect to such amounts shall be made not later than 30 days after the close of the taxable year in which the distribution is made.

(d) *Foreign tax election.* If an investment company to which section 853 is applicable for the taxable year makes a distribution as provided in subsection (a) of this section, the shareholders shall consider the amounts described in section 853 (b) (2) allocable to such distribution as paid or received, as the case may be, in the taxable year in which the distribution is made.

§ 1.855–1 Dividends paid by regulated investment company after close of taxable year.

(a) *General rule.* In—

(1) Determining under section 852 (a) and paragraph (a) of § 1.852–1 whether the deduction for dividends paid during the taxable year (without regard to capital gain dividends) by a regulated investment company equals or exceeds 90 percent of its investment company taxable income (determined without regard to the provisions of section 852 (b) (2) (D)),

(2) Computing its investment company taxable income (under section 852 (b) (2) and § 1.852–3), and

(3) Determining the amount of capital gain dividends (as defined in section 852(b)(3) and paragraph (c) of § 1.852–4 paid during the taxable year,

any dividend (or portion thereof) declared by the investment company either before or after the close of the taxable year but in any event before the time prescribed by law for the filing of its return for the taxable year (including the period of any extension of time granted for filing such return) shall, to the extent the company so elects in such return, be treated as having been paid during such taxable year. This rule is applicable only if the entire amount of such dividend is actually distributed to the shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration.

(b) *Election*—(1) *Method of making election.* The election must be made in the return filed by the company for the taxable year. The election shall be made by the taxpayer (the regulated investment company) by treating the dividend (or portion thereof) to which such election applies as a dividend paid during the taxable year in computing its investment company taxable income, or if the dividend (or portion thereof) to which such election applies is to be designated by the company as a capital gain dividend, in computing the amount of capital gain dividends paid during such taxable year. The election provided in section 855 (a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of section 852 (c) and § 1.852–5) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year (not including distributions with respect to which an election has been made for a prior year under section 855 (a)). The dividend or portion thereof, with respect to which the regulated investment company has made a valid election under section 855 (a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(2) *Irrevocability of the election.* After the expiration of the time for filing the return for the taxable year for which an election is made under section 855 (a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) *Receipt by shareholders.* Under section 855 (b), the dividend or portion thereof, with respect to which a valid election has been made, will be includible in the gross income of the shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(d) *Examples.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example (1). The X Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000. During that year the company distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1955, the company declared a dividend of $37,000 payable to shareholders on March 20, 1955. Such dividend consisted of the first regular quarterly dividend for 1955 of $25,000 plus an additional $12,000 representing that part of the taxable income for 1954 which was not distributed in 1954. On March 15, 1955, the X Company filed its Federal income tax return and elected therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1955, as having been paid during the taxable year 1954. Assuming that the X Company actually distributed the entire amount of the dividend of $37,000 on March 20, 1955, an amount equal to $12,000 thereof will be treated for the purposes of section 852 (a) as having been paid during the taxable year 1954. Such amount ($12,000) will be considered by the X Company as a distribution out of the earnings and profits for the taxable year 1954, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them.

Example (2). The Y Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000, and for 1955 taxable income (and earnings or profits) of $125,000. On January 1, 1954, the company had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1954 the company distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1955, the company declared a dividend of $65,000 payable to shareholders on March 31, 1955. On March 15, 1955, the Y Company filed its Federal income tax return in which it included $40,000 of the total dividend of $65,000 payable to shareholders on March 31, 1955, as a dividend paid by it during the taxable year 1954. On March 31, 1955, the Y Company distributed the entire amount of the dividend of $65,000 declared on March 5, 1955. The election under section 855 (a) is valid only to the extent of $15,000, the amount of the undistributed earnings and profits for 1954 ($100,000 earnings and profits less $85,000 distributed during 1954). The remainder ($50,000) of the $65,000 dividend paid on March 31, 1955, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Company out of earnings and profits for the taxable year 1955. Assuming that the only other distribution by the Y Company during 1955 was a distribution of $75,000 paid as a dividend on October 31, 1955, the total amount of the distribution of $65,000 paid on March 31, 1955, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Company will treat the amount of $15,000 as a distribution of the earnings or profits of the company for the taxable year 1954, and the remaining $50,000 as a distribution of the earnings or profits for the year 1955. The distribution of $75,000 on October 31, 1955, is, of course, a taxable dividend out of the earnings and profits for the year 1955.

(e) *Notice to shareholders.* Section 855 (c) provides that in the case of dividends, with respect to which a regulated investment company has made an election under section 855 (a), any notice to shareholders required under subchapter M, chapter 1 of the Code, with respect to such amounts, shall be made not later than 30 days after the close of the taxable year in which the distribution is made. Thus, the notice requirements of section 852(b)(3)(C) and paragraph (c) of § 1.852–4 with respect to capital gain dividends, section 853(c) and § 1.853–3 with respect to allowance to shareholder of foreign tax credit, and section 854 (b) (2) and § 1.854–2 with respect to the amount of a distribution which may be treated as a dividend, may be satisfied with respect to amounts to which section 855 (a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 30 days after the close of the taxable year in which the distribution is made. If the notice under section 855 (c) relates to an election with respect to any capital gain dividends, such capital gain dividends shall be aggregated by the investment company with the designated capital gain dividends actually paid during the taxable year to which the election applies (not including such dividends with respect to which an election has been made for a prior year under section 855) for the purpose of determining whether the aggregate of the designated capital gain dividends with respect to such taxable year of the company is greater than the excess of the net long-term capital gain over the net short-term capital loss of the company. See section 852 (b) (3) (C) and paragraph (c) of § 1.852–4.

(f) *Foreign tax election.* Section 855 (d) provides that in the case of an election made under section 853 (relating to foreign taxes), the shareholder of the investment company shall consider the foreign income received, and the foreign tax paid, as received and paid, respectively, in the shareholder's taxable year in which distribution is made.

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

DETERMINATION OF SOURCES OF INCOME

§ 1.861 Statutory provisions; income from sources within the United States.

SEC. 861. *Income from sources within the United States*—(a) *Gross income from sources within United States.* The following items of gross income shall be treated as income from sources within the United States:

(1) *Interest.* Interest from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including—

(A) Interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States,

(B) Interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Secretary or his delegate that less than 20 percent of the gross income of such resident payor or domestic corporation has been derived from sources within the United States, as determined under the provisions of this part, for the 3-year period ending with the close of the taxable year of such payor preceding the payment of such interest, or for such part of such period as may be applicable, and

(C) Income derived by a foreign central bank of issue from bankers' acceptances.

(2) *Dividends.* The amount received as dividends—

(A) From a domestic corporation other than a corporation entitled to the benefits

of section 931, and other than a corporation less than 20 percent of whose gross income is shown to the satisfaction of the Secretary or his delegate to have been derived from sources within the United States, as determined under the provisions of this part, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence), or

(B) From a foreign corporation unless less than 50 percent of the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this part; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources; but dividends from a foreign corporation shall, for purposes of subpart A of part III (relating to foreign tax credit), be treated as income from sources without the United States to the extent exceeding the amount of the deduction allowable under section 245 in respect of such dividends.

(3) *Personal services.* Compensation for labor or personal services performed in the United States; except that compensation for labor or services performed in the United States shall not be deemed to be income from sources within the United States if—

(A) The labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year,

(B) Such compensation does not exceed $3,000 in the aggregate, and

(C) The compensation is for labor or services performed as an employee of or under a contract with—

(i) A nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(ii) A domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such corporation.

(4) *Rentals and royalties.* Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property.

(5) *Sale of real property.* Gains, profits, and income from the sale of real property located in the United States.

(6) *Sale of personal property.* Gains, profits, and income derived from the purchase of personal property without the United States (other than within a possession of the United States) and its sale within the United States.

(b) *Taxable income from sources within United States.* From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

§ 1.861–1 Income from sources within the United States.

(a) *Categories of income.* Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder determine the sources of income for purposes of the income tax. These sections explicitly allocate certain important sources of income to the United States or to areas outside the United States, as the case may be; and, with respect to the remaining income (particularly that derived partly from sources within and partly from sources without the United States), authorize the Secretary or his delegate to determine the income derived from sources within the United States, either by rules of separate allocation or by processes or formulas of general apportionment. The statute provides for the following three categories of income:

(1) *Within the United States.* The gross income from sources within the United States, consisting of the items of gross income specified in section 861 (a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863 (a). See §§ 1.861–2 to 1.861–7, inclusive, and § 1.863–1. The taxable income from sources within the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 861 (b) and 863 (a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.861–8 and 1.863–1.

(2) *Without the United States.* The gross income from sources without the United States, consisting of the items of gross income specified in section 862 (a) plus the items of gross income allocated or apportioned to such sources in accordance with section 863 (a). See §§ 1.862–1 and 1.863–1. The taxable income from sources without the United States, in the case of such income, shall be determined by deducting therefrom, in accordance with sections 862 (b) and 863 (a), the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. See §§ 1.862–1 and 1.863–1.

(3) *Partly within and partly without the United States.* The gross income derived from sources partly within and partly without the United States, consisting of the items specified in section 863 (b) (1), (2), and (3). The taxable income allocated or apportioned to sources within the United States, in the case of such income, shall be determined in accordance with section 863 (a) or (b). See §§ 1.863–2 to 1.863–5, inclusive.

(b) *Taxable income from sources within the United States.* The taxable income from sources within the United States shall consist of the taxable income described in paragraph (a) (1) of this section plus the taxable income allocated or apportioned to such sources, as indicated in paragraph (a) (3) of this section.

(c) *Computation of income.* If a taxpayer has gross income from sources within or without the United States, together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated; and the taxable income from sources within the United States shall be separately computed therefrom.

§ 1.861–2 Interest.

(a) *General.* There shall be included in the gross income from sources within the United States all interest received or accrued, as the case may be, from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except—

(1) *Deposits.* Interest paid on deposits with persons, including individuals, partnerships, or corporations, carrying on the banking business, to persons not engaged in business within the United States;

(2) *Payer deriving income abroad.* Interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that less than 20 percent of the gross income of such resident payer or domestic corporation has been derived from sources within the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of the payer which precedes the payment of such interest, or for such part of that period as may be applicable; and

(3) *Bankers' acceptances.* Income derived by a foreign central bank of issue from bankers' acceptances. A foreign central bank of issue means a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. Such banks are generally the custodians of the banking reserves of their countries.

(b) *Interest on refunds.* Interest received from the United States on a refund of Federal income taxes constitutes income from sources within the United States.

(c) *Statement with return.* Any taxpayer who excludes from gross income items of the type specified in paragraph (a) (1), (2), or (3) of this section shall file with his return a statement setting forth the amount of such income and such information as may be necessary to show that the income is of the type specified therein.

§ 1.861–3 Dividends.

(a) *General.* Gross income from sources within the United States includes

dividends, as defined by section 316 and the regulations thereunder, from—

(1) *Domestic corporation.* A domestic corporation other than one entitled to the benefits of section 931, and other than a corporation less than 20 percent of the gross income of which is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) to have been derived from sources within the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends, or for such part of such period as the corporation has been in existence; or

(2) *Foreign corporation.* A foreign corporation unless less than 50 percent of its gross income for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends, or for such part of such period as it has been in existence, was derived from sources within the United States, as determined under the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources. However, for purposes of sections 901 to 905, inclusive, and the regulations thereunder, relating to the foreign tax credit, dividends from a foreign corporation shall be treated as income from sources without the United States to the extent exceeding the amount of the deduction allowable under section 245 in respect of such dividends.

(b) *Presumption as to source.* Dividends will be treated as income from sources within the United States (except for purposes of sections 901 to 905, inclusive, and the regulations thereunder) unless the taxpayer submits with his return sufficient data to establish to the satisfaction of the district director (or, if applicable, the Director of International Operations) that, in accordance with paragraph (a) (1) or (2) of this section, they are not income from sources within the United States.

§ 1.861–4 Compensation for labor or personal services.

(a) *General.* Gross income from sources within the United States includes compensation for labor or personal services performed in the United States regardless of the residence of the payer, of the place in which the contract for service was made, or of the place of payment; except that such compensation shall be deemed not to be income from sources within the United States, if—

(1) The labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year;

(2) The compensation does not exceed $3,000 in the aggregate; and

(3) The compensation is for labor or services performed as an employee of, or under a contract with—

(i) A nonresident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(ii) A domestic corporation, if the labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by that corporation.

(b) *Amount includible in gross income.* If a specific amount is paid for labor or personal services performed in the United States, that amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis; that is, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

(c) *Coastwise travel.* Except as to income excluded by paragraph (a) of this section, wages received for services rendered inside the territorial limits of the United States and wages of an alien seaman earned on a coastwise vessel are to be regarded as from sources within the United States.

§ 1.861–5 Rentals and royalties.

Gross income from sources within the United States includes rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the United States, patents, copyrights, the use of, or for the privilege of using, in secret processes and formulas, goodwill, trade-marks, trade brands, franchises, and other like property. The income arising from the rental of property, whether tangible or intangible, located within the United States, or from the use of property, whether tangible or intangible, within the United States, is from sources within the United States.

§ 1.861–6 Sale of real property.

Gross income from sources within the United States includes gain, computed under the provisions of section 1001 and the regulations thereunder, derived from the sale or other disposition of real property located in the United States. For the treatment of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code, and the regulations thereunder.

§ 1.861–7 Sale of personal property.

(a) *General.* Gains, profits, and income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which the property is sold. Thus, gross income from sources within the United States includes gains, profits, and income derived from the purchase of personal property without the United States and its sale within the United States.

(b) *Purchase within a possession.* Notwithstanding paragraph (a) of this section, income derived from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States. See section 863 (b) (3) and § 1.863–2.

(c) *Country in which sold.* For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. However, in any case in which the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, the foregoing rules will not be applied. In such cases, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred.

(d) *Production and sale.* For provisions respecting the source of income derived from the sale of personal property produced by the taxpayer, see section 863(b)(2) and paragraphs (b) of §§ 1.863–1 and 1.863–2.

(e) *Section 306 stock.* For determining the source of gain on the disposition of section 306 stock, see section 306 (f) and the regulations thereunder.

§ 1.861–8 Computation of taxable income from sources within the United States.

(a) *General.* From the items of gross income specified in §§ 1.861–2 to 1.861–7, inclusive, as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.

Example. A taxpayer engaged in trade or business receives for the taxable year gross income from all sources in the amount of $180,000, one-fifth of which ($36,000) is from sources within the United States, computed as follows:

Interest on bonds of a domestic corporation	$9,000
Dividends on stock of a domestic corporation	4,000

Royalty for the use within the United States of patents	$12,000
Gain from sale of real property located within the United States	11,000
Total	36,000

The remainder of the gross income is from sources without the United States, as determined under § 1.862–1. The expenses of the taxpayer for the year amount to $78,000. Of these expenses the amount of $8,000 is properly allocated to income from sources within the United States, and the amount of $40,000 is properly allocated to income from sources without the United States. The remainder of the expenses ($30,000) cannot be definitely allocated to any item or class of gross income. A ratable part thereof, based upon the relation of gross income from sources within the United States to the total gross income, shall be deducted in computing taxable income from sources within the United States. Thus, there are deducted from the $36,000 of gross income from sources within the United States expenses amounting to $14,000, representing $8,000 properly apportioned to the income from sources within the United States and $6,000 of the expenses (one-fifth thereof) which cannot definitely be allocated to any item or class of gross income. The remainder ($22,000) is the taxable income from sources within the United States.

(b) *Personal exemptions.* The deductions for the personal exemptions allowed by section 151 or 642 (b) shall not be taken into account for purposes of paragraph (a) of this section but shall be allowed as deductions from the taxable income computed thereunder, if and to the extent that such deductions are allowable for purposes of computing the taxable income of the taxpayer. See sections 641 (b), 873 (d), 904 (b), and 931 (e), and the regulations thereunder.

(c) *Special deductions.* The special deductions allowed in the case of a corporation by section 241 (relating to the deductions for partially tax-exempt interest, dividends received, etc.), section 922 (relating to Western Hemisphere trade corporations), and section 941 (relating to China Trade Act corporations) shall be taken into account for purposes of paragraph (a) of this section.

(d) *Exempt income.* No deduction shall be allowed under this section for the amount of any item or part thereof allocable to a class or classes of exempt income. See section 265 and the regulations thereunder.

§ 1.862 Statutory provisions; income from sources without the United States.

SEC. 862. *Income from sources without the United States*—(a) *Gross income from sources without United States.* The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in section 861 (a) (1);

(2) Dividends other than those derived from sources within the United States as provided in section 861 (a) (2);

(3) Compensation for labor or personal services performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties;

(5) Gains, profits, and income from the sale of real property located without the United States; and

(6) Gains, profits, and income derived from the purchase of personal property within the United States and its sale without the United States.

(b) *Taxable income from sources without United States.* From the items of gross income specified in subsection (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as taxable income from sources without the United States.

§ 1.862–1 Income specifically from sources without the United States.

(a) *Gross income.* The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that specified in section 861 (a) (1) as being derived from sources within the United States;

(2) Dividends other than those derived from sources within the United States as provided in section 861 (a) (2);

(3) Compensation for labor or personal services performed without the United States (for the treatment of compensation for labor or personal services performed partly within the United States and partly without the United States, see paragraph (b) of § 1.861–4);

(4) Rentals or royalties from property located without the United Sates or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, without the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property;

(5) Gains, profits, and income from the sale of real property located without the United States; and

(6) Gains, profits, and income derived from the purchase of personal property within the United States and its sale without the United States. Income derived from the purchase of personal property within the United States and its sale within a possession of the United States shall be treated as derived entirely from within that possession of the United States. For determining the time and place of sale of personal property for purposes of this subparagraph, see paragraph (c) of § 1.861–7.

(b) *Taxable income.* The taxable income from sources without the United States, in the case of the items of gross income specified in paragraph (a) of this section, shall be determined on the same basis as that used in § 1.861–8 for determining the taxable income from sources within the United States.

§ 1.863 Statutory provisions; items not specified in section 861 or 862.

SEC. 863. *Items not specified in section 861 or 862*—(a) *Allocation under regulations.* Items of gross income, expenses, losses, and deductions, other than those specified in sections 861 (a) and 862 (a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary or his delegate. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the taxable income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States.

(b) *Income partly from within and partly from without the United States.* In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary or his delegate.

Gains, profits, and income—

(1) From transportation or other services rendered partly within and partly without the United States,

(2) From the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, shall be treated as derived partly from sources within and partly from sources without the United States.

§ 1.863–1 Allocation of gross income under section 863(a).

(a) *General.* Items of gross income other than those specified in section 861 (a) (§§ 1.861–2 to 1.861–7, inclusive) and section 862(a) (§ 1.862–1) shall be allocated or apportioned to sources within or without the United States, as provided in section 863(a); however, see § 1.863–2 for alternative method of determining the taxable income from sources within the United States in the case of the items specified in paragraph (b) of § 1.863–2.

(b) *Natural resources.* (1) The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If, however, it is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) that, due to the peculiar conditions of production and sale in a specific case or for other reasons, not all of the gross income derived therefrom should be allocated to sources within the United States, an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided by section 863 (b) and § 1.863–2.

(2) If the Commissioner determines that the application of the provisions of

tions thereunder.

subparagraph (1) of this paragraph does not result in a proper allocation or apportionment of income, the Commissioner may make such other allocation or apportionment as will, in his opinion, more clearly reflect the proper source of the income to which such subparagraph applies. This subparagraph shall apply with respect to taxable years beginning after December 31, 1957.

(c) *Taxable income.* The taxable income from sources within or without the United States, in the case of the items of gross income allocated under section 863 (a), shall be determined on the same basis as that used in § 1.861–8 for determining the taxable income from sources within the United States. See also paragraph (b) of § 1.862–1.

§ 1.863–2 Income derived partly from sources within and partly from sources without the United States.

(a) *General.* Section 863(b) provides an alternative method for determining the taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method the entire taxable income in the case of such income is first determined by deducting the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income. Then, pursuant to processes or formulas of general apportionment prescribed by the Secretary or his delegate, a portion of such entire taxable income is determined as being attributable to sources within the United States. Thus, the income treated as derived partly from sources within and partly from sources without the United States may be allocated to sources within or without the United States pursuant to § 1.863–1 or apportioned to such sources in accordance with the method described in this section.

(b) *Applicable items.* The income to which this section applies (and which is treated as derived partly from sources within and partly from sources without the United States) shall consist of gains, profits, and income—

(1) From transportation or other services rendered partly within and partly without the United States;

(2) From the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States.

(c) *Cross reference.* For allocation or apportionment under § 1.863–1 or this section in the case of the principal items to which this section applies, see §§ 1.863–3, 1.863–4, and 1.863–5.

§ 1.863–3 Income from the sale of personal property derived partly from within and partly from without the United States.

(a) *General*—(1) *Classes of income.* Income from the sale of property to which paragraph (b) (2) and (3) of § 1.863–2 applies is divided into two classes for purposes of this section, namely, income which is treated as derived partly from sources within the United States and partly from sources within a foreign country, and income which is treated as derived partly from sources within the United States and partly from sources within a possession of the United States.

(2) *Definition.* For purposes of this section, the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged. For determining the time and place of sale of personal property for purposes of this section, see paragraph (c) of § 1.861–7.

(b) *Income partly from sources within a foreign country*—(1) *General.* This paragraph relates to gains, profits, and income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States. Pursuant to section 863 (b) such items shall be treated as derived partly from sources within the United States and partly from sources within a foreign country.

(2) *Allocation or apportionment.* The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in this subparagraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of § 1.861–8 shall be taken into account.

Example (1). Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the district director (or, if applicable, the Director of International Operations) that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the taxable income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return for the taxable year.

Example (2). (i) Where an independent factory or production price has not been established as provided under example (1), the taxable income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

(ii) Of the amount of taxable income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such taxable income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country.

(iii) The term "gross sales", as used in this example, refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States.

(iv) The term "property", as used in this example, includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of taxation shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis.

(v) Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch, or agent in the United States.

Example (3). Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas herein prescribed the taxable income derived from sources within the United States.

(c) *Income partly from sources within a possession of the United States*—(1) *General.* This paragraph relates to gains, profits, and income which, pursuant to section 863 (b), are treated as derived partly from sources within the United States and partly from sources within a possession of the United States.

The items so treated are described in subparagraphs (3) and (4) of this paragraph.

(2) *Allocation or apportionment.* The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in subparagraphs (3) and (4) of this paragraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of § 1.861–8 shall be taken into account.

(3) *Personal property produced and sold.* This subparagraph relates to gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States.

Example (1). Same as example (1) under paragraph (b) (2) of this section.

Example (2). (i) Where an independent factory or production price has not been established as provided under example (1), the taxable income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

(ii) Of the amount of taxable income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the possession of the United States. The remaining one-half of such taxable income shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the amount of the taxpayer's business for the taxable year or period within the United States, and the denominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) The "business of the taxpayer", as used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the production (in whole or in part) of personal property within the United States and its sale within a possession of the United States or to the production (in whole or in part) of personal property within a possession of the United States and its sale within the United States. The term "property", as used in this example, includes only the property held or used to produce income which is derived from such sales.

Example (3). Same as example (3) under paragraph (b) (2) of this section.

(4) *Personal property purchased and sold.* This subparagraph relates to gross income derived from the purchase of personal property within a possession of the United States and its sale within the United States.

Example (1). (i) The taxable income shall first be computed by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

(ii) The amount of taxable income so determined shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being that percentage of such taxable income which the amount of the taxpayer's business for the taxable year or period within the United States bears to the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) The "business of the taxpayer", as that term is used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

Example (2). Same as example (3) under paragraph (b) (2) of this section.

§ 1.863–4 Transportation service.

(a) *General.* A taxpayer carrying on the business of transportation service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income.* The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (1) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (2) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services, such as the sale of money orders, shall be apportioned on the same basis as direct revenues from transportation services.

(c) *Allocation of costs or expenses.* In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with that part of the services which was wholly rendered in the United States shall be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies chargeable to voyage expenses shall ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage; and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the internal revenue laws shall be taken into account.

(d) *Items not included as costs or expenses*—(1) *Taxes and interest.* Income, war profits, and excess profits taxes shall not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and, for such purpose, interest and other expenses for the use of borrowed capital shall not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. See paragraph (f) (2) of this section.

(2) *Other business activity and general expenses.* If a taxpayer subject to this section is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses, including taxes, properly apportioned or allocated to such other business shall be excluded both from the deductions and from the apportionment process prescribed in paragraph (c) of this section; but, for the purpose of determining taxable income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income. See paragraph (f) (3) of this section.

(3) *Personal exemptions and special deductions.* The deductions for the personal exemptions, and the special deductions described in paragraph (c) of § 1.861–8, shall not be taken into account for purposes of paragraph (c) of this section.

determined by multiplying

(e) *Property used while within the United States*—(1) *General.* The value of the property used shall be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken shall be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year.

(2) *Average property.* For ships, the average shall be determined upon a daily basis for each ship, and the amount to be apportioned for each ship as assets employed within the United States shall be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(3) *Current assets.* Current assets shall be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries shall be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries shall be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States shall be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries.

(f) *Taxable income*—(1) *General.* In computing taxable income from sources within the United States there shall be allowed as deductions from the gross income from such sources, determined in accordance with paragraph (b) of this section, (i) the expenses of the transportation business carried on within the United States (as determined under paragraphs (c) and (d) of this section) and (ii) the expenses and deductions determined in accordance with this paragraph.

(2) *Interest and taxes.* Interest and income, war-profits, and excess profits taxes shall be excluded from the apportionment process, as indicated in paragraph (d) of this section; but, for the purpose of computing taxable income there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part of all interest deductible under section 163 and of all income, war-profits, and excess profits taxes deductible under section 164, paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. The ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income, from such transportation service.

(3) *General expenses.* General expenses, losses, or deductions shall be deducted under this paragraph to the extent indicated in paragraph (d) (2) of this section.

(4) *Personal exemptions.* The deductions for the personal exemptions shall be allowed under this paragraph to the same extent as provided by paragraph (b) of § 1.861–8.

(5) *Special deductions.* The special deductions allowed in the case of a corporation by sections 241, 922, and 941 shall be allowed under this paragraph to the same extent as provided by paragraph (c) of § 1.861–8.

(g) *Allocation based on books of account.* Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer subject to this section, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which more clearly reflects the income derived from sources within the United States than does the process prescribed by paragraphs (b) to (f), inclusive, of this section.

§ 1.863–5 Telegraph and cable services.

(a) *General.* A taxpayer carrying on the business of transmission of telegraph or cable messages between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income.* The gross income from sources within the United States derived from such services shall be determined by adding the gross revenues derived from messages originating in the United States and amounts collected abroad on collect messages originating in the United States and then deducting from such sum amounts paid or accrued for transmission of messages beyond the taxpayer's own circuit. Amounts received by the taxpayer in the United States with respect to collect messages originating without the United States shall be excluded from such gross income.

(c) *Taxable income.* In computing taxable income from sources within the United States, the following items shall be allowed as deductions from the gross income determined in accordance with paragraph (b) of this section:

(1) All expenses incurred in the United States (not including any general overhead expenses) incident to the carrying on of the business in the United States;

(2) All direct expenses incurred abroad in the transmission of messages originating in the United States (not including any general overhead expenses or maintenance, repairs, and depreciation of cables and not including any amount already deducted in computing gross income);

(3) Depreciation of property (other than cables) located in the United States and used in the trade or business therein; and,

(4) A proportionate part of the general overhead expenses (not including any items incurred abroad corresponding to those enumerated in subparagraphs (1), (2), and (3) of this paragraph) and of maintenance, repairs, and depreciation of cables of the entire cable system of the enterprise, based on the ratio which the number of words originating in the United States bears to the total words transmitted by the enterprise.

(5) The deductions for the personal exemptions, and the special deductions allowed by sections 241, 922, and 941, but only to the extent provided by paragraphs (b) and (c) of § 1.861–8.

§ 1.863–6 Income from sources within a foreign country or possession of the United States.

The principles applied in §§ 1.861–1 to 1.863–5, inclusive, for determining the gross and the taxable income from sources within and without the United States shall be applied, for purposes of the income tax, in determining the gross and the taxable income from sources within and without a foreign country, or within and without a possession of the United States.

§ 1.864 Statutory provisions; definitions.

SEC. 864. *Definitions.* For purposes of this part, the word "sale" includes "exchange"; the word "sold" includes "exchanged"; and the word "produced" includes "created", "fabricated", "manufactured", "extracted", "processed", "cured", or "aged".

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

NONRESIDENT ALIEN INDIVIDUALS

§ 1.871 Statutory provisions; tax on nonresident alien individuals.

SEC. 871. *Tax on nonresident alien individuals*—(a) *No United States business and gross income of not more than $15,400*—(1) *Imposition of tax.* Except as otherwise provided in subsection (b) there is hereby imposed for each taxable year, in lieu of the tax imposed by section 1, on the amount received, by every nonresident alien individual not engaged in trade or business within the United States, from sources within the United States, as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (including amounts described in section 402(a)(2), section 403(a)(2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets), a tax of 30 percent of such amount.

(2) *Capital gains of aliens temporarily present in the United States.* In the case of a nonresident alien individual not engaged in trade or business in the United States, there is hereby imposed for each taxable year, in addition to the tax imposed by paragraph (1)—

The items so treated are described in subparagraphs (3) and (4) of this paragraph.

(2) *Allocation or apportionment.* The taxable income from sources within the United States, in the case of the items to which this paragraph applies, shall be determined according to the examples set forth in subparagraphs (3) and (4) of this paragraph. For such purposes, the deductions for the personal exemptions shall not be taken into account, but the special deductions described in paragraph (c) of § 1.861–8 shall be taken into account.

(3) *Personal property produced and sold.* This subparagraph relates to gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States.

Example (1). Same as example (1) under paragraph (b)(2) of this section.

Example (2). (i) Where an independent factory or production price has not been established as provided under example (1), the taxable income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a possession of the United States, or produced (in whole or in part) by the taxpayer within a possession of the United States and sold within the United States, the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

(ii) Of the amount of taxable income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the possession of the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the possession of the United States. The remaining one-half of such taxable income shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States, being determined by multiplying such one-half by a fraction the numerator of which consists of the amount of the taxpayer's business for the taxable year or period within the United States, and the denominator of which consists of the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) The "business of the taxpayer", as used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies consumed in the regular course of business, plus the amounts received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the production (in whole or in part) of personal property within the United States and its sale within a possession of the United States or to the production (in whole or in part) of personal property within a possession of the United States and its sale within the United States. The term "property", as used in this example, includes only the property held or used to produce income which is derived from such sales.

Example (3). Same as example (3) under paragraph (b) (2) of this section.

(4) *Personal property purchased and sold.* This subparagraph relates to gross income derived from the purchase of personal property within a possession of the United States and its sale within the United States.

Example (1). (i) The taxable income shall first be computed by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.

(ii) The amount of taxable income so determined shall be apportioned in accordance with the total business of the taxpayer within the United States and within the possession of the United States, the portion attributable to sources within the United States being that percentage of such taxable income which the amount of the taxpayer's business for the taxable year or period within the United States bears to the amount of the taxpayer's business for the taxable year or period both within the United States and within the possession of the United States.

(iii) The "business of the taxpayer", as that term is used in this example, shall be measured by the amounts which the taxpayer paid out during the taxable year or period for wages, salaries, and other compensation of employees and for the purchase of goods, materials, and supplies sold or consumed in the regular course of business, plus the amount received during the taxable year or period from gross sales, such expenses, purchases, and gross sales being limited to those attributable to the purchase of personal property within a possession of the United States and its sale within the United States.

Example (2). Same as example (3) under paragraph (b) (2) of this section.

§ 1.863–4 Transportation service.

(a) *General.* A taxpayer carrying on the business of transportation service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income.* The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (1) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (2) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services, such as the sale of money orders, shall be apportioned on the same basis as direct revenues from transportation services.

(c) *Allocation of costs or expenses.* In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with that part of the services which was wholly rendered in the United States shall be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies chargeable to voyage expenses shall ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage; and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the internal revenue laws shall be taken into account.

(d) *Items not included as costs or expenses*—(1) *Taxes and interest.* Income, war profits, and excess profits taxes shall not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and, for such purpose, interest and other expenses for the use of borrowed capital shall not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. See paragraph (f) (2) of this section.

(2) *Other business activity and general expenses.* If a taxpayer subject to this section is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses, including taxes, properly apportioned or allocated to such other business shall be excluded both from the deductions and from the apportionment process prescribed in paragraph (c) of this section; but, for the purpose of determining taxable income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income. See paragraph (f) (3) of this section.

(3) *Personal exemptions and special deductions.* The deductions for the personal exemptions, and the special deductions described in paragraph (c) of § 1.861–8, shall not be taken into account for purposes of paragraph (c) of this section.

(e) *Property used while within the United States*—(1) *General.* The value of the property used shall be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken shall be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year.

(2) *Average property.* For ships, the average shall be determined upon a daily basis for each ship, and the amount to be apportioned for each ship as assets employed within the United States shall be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(3) *Current assets.* Current assets shall be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries shall be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries shall be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States shall be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries.

(f) *Taxable income*—(1) *General.* In computing taxable income from sources within the United States there shall be allowed as deductions from the gross income from such sources, determined in accordance with paragraph (b) of this section, (i) the expenses of the transportation business carried on within the United States (as determined under paragraphs (c) and (d) of this section) and (ii) the expenses and deductions determined in accordance with this paragraph.

(2) *Interest and taxes.* Interest and income, war-profits, and excess profits taxes shall be excluded from the apportionment process, as indicated in paragraph (d) of this section; but, for the purpose of computing taxable income there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part of all interest deductible under section 163 and of all income, war-profits, and excess profits taxes deductible under section 164, paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. The ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income, from such transportation service.

(3) *General expenses.* General expenses, losses, or deductions shall be deducted under this paragraph to the extent indicated in paragraph (d) (2) of this section.

(4) *Personal exemptions.* The deductions for the personal exemptions shall be allowed under this paragraph to the same extent as provided by paragraph (b) of § 1.861–8.

(5) *Special deductions.* The special deductions allowed in the case of a corporation by sections 241, 922, and 941 shall be allowed under this paragraph to the same extent as provided by paragraph (c) of § 1.861–8.

(g) *Allocation based on books of account.* Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer subject to this section, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which more clearly reflects the income derived from sources within the United States than does the process prescribed by paragraphs (b) to (f), inclusive, of this section.

§ 1.863–5 Telegraph and cable services.

(a) *General.* A taxpayer carrying on the business of transmission of telegraph or cable messages between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(b) *Gross income.* The gross income from sources within the United States derived from such services shall be determined by adding the gross revenues derived from messages originating in the United States and amounts collected abroad on collect messages originating in the United States and then deducting from such sum amounts paid or accrued for transmission of messages beyond the taxpayer's own circuit. Amounts received by the taxpayer in the United States with respect to collect messages originating without the United States shall be excluded from such gross income.

(c) *Taxable income.* In computing taxable income from sources within the United States, the following items shall be allowed as deductions from the gross income determined in accordance with paragraph (b) of this section:

(1) All expenses incurred in the United States (not including any general overhead expenses) incident to the carrying on of the business in the United States;

(2) All direct expenses incurred abroad in the transmission of messages originating in the United States (not including any general overhead expenses or maintenance, repairs, and depreciation of cables and not including any amount already deducted in computing gross income);

(3) Depreciation of property (other than cables) located in the United States and used in the trade or business therein; and,

(4) A proportionate part of the general overhead expenses (not including any items incurred abroad corresponding to those enumerated in subparagraphs (1), (2), and (3) of this paragraph) and of maintenance, repairs, and depreciation of cables of the entire cable system of the enterprise, based on the ratio which the number of words originating in the United States bears to the total words transmitted by the enterprise.

(5) The deductions for the personal exemptions, and the special deductions allowed by sections 241, 922, and 941, but only to the extent provided by paragraphs (b) and (c) of § 1.861–8.

§ 1.863–6 Income from sources within a foreign country or possession of the United States.

The principles applied in §§ 1.861–1 to 1.863–5, inclusive, for determining the gross and the taxable income from sources within and without the United States shall be applied, for purposes of the income tax, in determining the gross and the taxable income from sources within and without a foreign country, or within and without a possession of the United States.

§ 1.864 Statutory provisions; definitions.

SEC. 864. *Definitions.* For purposes of this part, the word "sale" includes "exchange"; the word "sold" includes "exchanged"; and the word "produced" includes "created", "fabricated", "manufactured", "extracted", "processed", "cured", or "aged".

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

NONRESIDENT ALIEN INDIVIDUALS

§ 1.871 Statutory provisions; tax on nonresident alien individuals.

SEC. 871. *Tax on nonresident alien individuals*—(a) *No United States business and gross income of not more than $15,400*—(1) *Imposition of tax.* Except as otherwise provided in subsection (b) there is hereby imposed for each taxable year, in lieu of the tax imposed by section 1, on the amount received, by every nonresident alien individual not engaged in trade or business within the United States, from sources within the United States, as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (including amounts described in section 402(a)(2), section 403(a)(2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets), a tax of 30 percent of such amount.

(2) *Capital gains of aliens temporarily present in the United States.* In the case of a nonresident alien individual not engaged in trade or business in the United States, there is hereby imposed for each taxable year, in addition to the tax imposed by paragraph (1)—

(A) If he is present in the United States for a period or periods aggregating less than 90 days during such taxable year—a tax of 30 percent of the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected during his presence in the United States exceed his losses, allocable to sources within the United States, from such sales or exchanges effected during such presence; or

(B) If he is present in the United States for a period or periods aggregating 90 days or more during such taxable year—a tax of 30 percent of the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during such year exceed his losses, allocable to sources within the United States, from such sales or exchanges effected at any time during such year.

For purposes of this paragraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if such individual were engaged in trade or business in the United States, except that such gains and losses shall be computed without regard to section 1202 (relating to deduction for capital gains) and such losses shall be determined without the benefits of the capital loss carryover provided in section 1212.

(b) *No United States business and gross income of more than $15,400.* A nonresident alien individual not engaged in trade or business within the United States shall be taxable without regard to subsection (a) if during the taxable year the sum of the aggregate amount received from the sources specified in subsection (a) (1), plus the amount by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges (determined in accordance with subsection (a) (2)) is more than $15,400, except that—

(1) The gross income shall include only income from the sources specified in subsection (a) (1) plus any gain (to the extent provided in subchapter P; sec. 1201 and following, relating to capital gains and losses) from a sale or exchange of a capital asset if such gain would be taken into account were the tax being determined under subsection (a) (2);

(2) The deductions (other than the deduction for charitable contributions and gifts provided in section 873 (c)) shall be allowed only if and to the extent that they are properly allocable to the gross income from the sources specified in subsection (a), except that any loss from the sale or exchange of a capital asset shall be allowed (to the extent provided in subchapter P without the benefit of the capital loss carryover provided in section 1212) if such loss would be taken into account were the tax being determined under subsection (a) (2).

If (without regard to this sentence) the amount of the taxes imposed in the case of such an individual under section 1 or under section 1201(b), minus the sum of the credits under sections 34 and 35, is an amount which is less than 30 percent of the sum of—

(A) The aggregate amount received from the sources specified in subsection (a) (1), plus

(B) The amount, determined under subsection (a) (2), by which gains from sales or exchanges of capital assets exceed losses from such sales or exchanges,

then this subsection shall not apply and subsection (a) shall apply. For purposes of this subsection, the term "aggregate amount received from the sources specified in subsection (a) (1)" shall be applied without any exclusion under section 116.

(c) *United States business.* A nonresident alien individual engaged in trade or business within the United States shall be taxable without regard to subsection (a). For purposes of part I, this section, sections 881 and 882, and chapter 3, the term "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year, but does not include the performance of personal services—

(1) For a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(2) For an office or place of business maintained by a domestic corporation in a foreign country or in a possession of the United States,

by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. Such term does not include the effecting, through a resident broker, commission agent, or custodian, of transactions in the United States in stocks or securities, or in commodities (if of a kind customarily dealt in on an organized commodity exchange, if the transaction is of the kind customarily consummated at such place, and if the alien, partnership, or corporation has no office or place of business in the United States at any time during the taxable year through which or by the direction of which such transactions in commodities are effected).

(d) *Doubling of tax.* For doubling of tax on citizens of certain foreign countries, see section 891.

[Sec. 871 as amended by secs. 40(a) and 41(a), Technical Amendments Act 1958 (72 Stat. 1638, 1639)]

§ 1.871–1 Taxation of aliens.

For purposes of the income tax, alien individuals are divided generally into two classes, namely, resident aliens and nonresident aliens. Resident aliens are, in general, taxable the same as citizens of the United States; that is, a resident alien is taxable on income derived from all sources, including sources without the United States. Nonresident aliens are taxable only on income from sources within the United States. For classification of nonresident aliens, see § 1.871–7. For determination of the sources of income, see §§ 1.861–1 to 1.863–6, inclusive.

§ 1.871–2 Determining residence of alien individuals.

(a) *General.* The term "nonresident alien individual" means an individual whose residence is not within the United States, and who is not a citizen of the United States. The term includes a nonresident alien fiduciary. For such purpose the term "fiduciary" shall have the meaning assigned to it by section 7701 (a) (6) and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration). For presumption as to an alien's nonresidence, see paragraph (b) of § 1.871–4.

(b) *Residence defined.* An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

§ 1.871–3 Residence of alien seamen.

In order to determine whether an alien seaman is a resident of the United States for purposes of the income tax, it is necessary to decide whether the presumption of nonresidence (as prescribed by paragraph (b) of § 1.871–4) is overcome by facts showing that he has established a residence in the United States. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel which is flying the United States flag and is engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the United States within the rules laid down in § 1.871–4, although the nature of his calling requires him to be absent for a long period from the place where his residence is established. An alien seaman may acquire such a residence at a sailors' boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078 or taking out first citizenship papers is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient.

§ 1.871–4 Proof of residence of aliens.

(a) *Rules of evidence.* The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein for purposes of the income tax.

(b) *Nonresidence presumed.* An alien, by reason of his alienage, is presumed to be a nonresident alien.

(c) *Presumption rebutted*—(1) *Departing alien.* In the case of an alien who presents himself for determination of tax liability before departure from the United States, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That the alien, at least six months before the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien, at least six months before the date he so presents himself, has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(2) *Other aliens.* In the case of other aliens, the presumption as to the alien's nonresidence may be overcome by proof—

(i) That the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws; or

(ii) That the alien has filed Form 1078 or its equivalent; or

(iii) Of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.

(d) *Certificate.* If, in the application of paragraphs (c) (1) (iii) or (2) (iii) of this section, the internal revenue officer or employee who examines the alien is in doubt as to the facts, such officer or employee may, to assist him in determining the facts, require a certificate or certificates setting forth the facts relied upon by the alien seeking to overcome the presumption. Each such certificate, which shall contain, or be verified by, a written declaration that it is made under the penalties of perjury, shall be executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months before the date of execution of the certificate or certificates.

§ 1.871–5 Loss of residence by an alien.

An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus, an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States.

§ 1.871–6 Duty of employer to determine status of alien employee.

(a) *Proof of status required.* If wages are paid to an alien without withholding the tax under chapter 3 of the Internal Revenue Code of 1954, or, if applicable, under section 143 of the Internal Revenue Code of 1939, except insofar as the regulations thereunder permit exemption from withholding, then the employer must be prepared to prove the status of the alien as provided in §§ 1.871–1 to 1.871–5, inclusive.

(b) *Evidence of residence.* An employer may rely upon the evidence of residence afforded by the fact that an alien has filed Form 1078 or an equivalent written statement. In the case of payments made after December 31, 1956, this statement or form shall be filed in the manner prescribed in § 1.1441–5. An employer need not secure Form 1078 or written statement from the alien employee if he is satisfied that the alien is a resident alien. An employer who seeks to account for failure to withhold in the past, if he did not at that time secure Form 1078 or its equivalent, is permitted to prove the former status of the alien by any competent evidence.

§ 1.871–7 Tax on nonresident alien individuals.

(a) *Classes of nonresident aliens.* For purposes of the income tax, nonresident alien individuals are divided into four classes:

(1) *Class 1.* Nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and receiving in such year an aggregate of not more than $15,400 gross income (determined without regard to section 116) from sources within the United States consisting of—

(i) Fixed or determinable annual or periodical income, and

(ii) Amounts constituting, or considered to be, gains from the sale or exchange of capital assets, as described in paragraph (b) of this section;

(2) *Class 2.* Nonresident alien individuals not engaged in trade or business within the United States at any time during the taxable year and receiving in such year an aggregate of more than $15,400 gross income (determined without regard to section 116) described under class 1;

(3) *Class 3.* Nonresident alien individuals who at any time during the taxable year are engaged in trade or business within the United States; and

(4) *Class 4.* Nonresident alien individuals who are bona fide residents of Puerto Rico during the entire taxable year.

Individuals within classes 1 to 3, inclusive, are subject to tax pursuant to the provisions of subpart A (section 871 and following), part II, subchapter N, chapter 1 of the Code, and the regulations thereunder. The provisions of those sections do not apply to individuals within class 4, but such individuals are subject to the tax imposed by section 1. See § 1.876–1. If the gross income of a nonresident alien individual includes income on which the tax is limited by tax convention, see paragraph (e) of this section.

(b) *No United States business; gross income of not more than $15,400—(1) Imposition of tax.* Except as otherwise provided by paragraph (e) of this section, a nonresident alien individual within class 1 is not subject to the tax imposed by section 1 but, pursuant to the provisions of section 871 (a), is liable to a flat tax of 30 percent upon the aggregate of the amounts determined under subparagraphs (2), (3), and (4) of this paragraph and received during the taxable year from sources within the United States. For this purpose the source of the income shall be determined in accordance with the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder. For the purposes of section 871 (a) (1) "amount received" means "gross income."

(2) *Fixed or determinable annual or periodical income—(i) Items subject to tax.* The tax of 30 percent applies to the gross amount received as fixed or determinable annual or periodical gains, profits, and income. Specific items of fixed or determinable annual or periodical income are enumerated in section 871 (a) (1) as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax as, for instance, royalties. As to the determination of fixed or determinable annual or periodical income, see paragraph (a) of § 1.1441–2. For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income, see section 306 (f) and the regulations thereunder.

(ii) *Losses.* In computing the income subject to tax under this subparagraph no deduction shall be allowed for any loss sustained during the taxable year.

(3) *Amounts considered to be capital gains—(i) Items subject to tax.* The tax of 30 percent also applies, pursuant to the provisions of section 871 (a) (1), to amounts received during the taxable year from sources within the United States which are described in section 402(a)(2), section 631 (b) and (c), section 1235, and for taxable years ending after September 2, 1958, section 403(a)(2) and are considered to be gains from the sale or exchange of capital assets. Thus, the tax applies to gain recognized on certain distributions by a qualified employees' trust where the total distributions, with respect to any employee, are paid to the distributee within one taxable year; to the gain recognized on certain payments under annuity contracts purchased by an employer for an employee under certain qualified annuity plans where the total payments are paid to the payee within one taxable year; to gain recognized under specified circumstances on the disposal of timber and coal and considered in accordance with section 1231 to be gain from the sale or exchange of a capital asset; and to gain recognized on certain transfers of patent rights by an individual.

(ii) *Ninety-day rule not applicable.* The provisions of section 871 (a) (2) do not apply to the gains described in this subparagraph; as a consequence, the taxpayer receiving these gains during a taxable year is subject to the tax of 30 percent thereon without regard to the 90-day rule of that section and even though he has not been present in the United States at any time during the taxable year.

(iii) *Recognized gain fully taxable.* The tax of 30 percent imposed upon the gains described in this subparagraph shall apply (*a*) to the full amount of gain recognized upon the transaction, (*b*) without regard to the alternative tax

imposed by section 1201 upon the excess of the net long-term capital gain over the net short-term capital loss, and (c) without regard to the deduction allowed by section 1202 in respect of capital gains.

(iv) *Losses.* In computing the gain subject to tax under this subparagraph no deduction shall be allowed for any loss sustained during the taxable year, even though the loss is taken into account under section 1231 in determining whether the gain is considered to be gain from the sale or exchange of a capital asset.

(4) *Capital gains and losses*—(i) *Items subject to tax.* The tax of 30 percent also applies, pursuant to the provisions of section 871 (a) (2), to the excess of capital gains derived from sources within the United States over capital losses allocable to such sources, determined under the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, and in accordance with the provisions of this subparagraph.

(ii) *Present less than 90 days.* If he has been present in the United States for a period or periods aggregating less than 90 days during the taxable year, a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is liable to a tax of 30 percent upon the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected during his presence in the United States exceed his losses, allocable to sources within the United States, from such sales or exchanges effected during such presence. Gains and losses from sales or exchanges of capital assets effected during the taxable year at times other than during such presence in the United States are not to be taken into account for this purpose.

(iii) *Present 90 days or more.* If he has been present in the United States for a period or periods aggregating 90 days or more during the taxable year, a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is liable to a tax of 30 percent upon the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during that year exceed his losses, allocable to sources within the United States, from sales or exchanges effected at any time during that year. Gains and losses from sales or exchanges effected at any time during the taxable year are to be taken into account for this purpose even though the alien individual is not present in the United States at the time the sales or exchanges are effected.

(iv) *Separate periods to be aggregated.* In computing the total period of presence in the United States for a taxable year, all separate periods of presence in the United States during the taxable year are to be aggregated.

(v) *Other provisions applicable.* For the purpose of the computation of the excess of capital gains over capital losses subject to tax under this subparagraph, gains and losses shall, subject to the 90-day rule of section 871 (a) (2), be taken into account only if, and to the extent that, they would be recognized and taken into account if the nonresident alien individual were engaged in trade or business within the United States, except that the gains and losses shall be computed without regard to the provisions of section 1202, relating to the deduction for capital gains, and the losses shall be determined without the benefits of the capital loss carryover provided in section 1212. For example, any amount (other than the gains specified in subparagraph (3) of this paragraph) which, under the provisions of subtitle A of the Code, is considered to be gain or loss from the sale or exchange of a capital asset shall be taken into account but only in accordance with this subdivision and subject to the provisions of section 873 and the regulations thereunder. Thus, an amount described in section 631(b) or (c) which is considered to be loss from the sale or exchange of a capital asset would be taken into account in such manner. Also, for example, no deduction shall be allowed, pursuant to the provisions of section 267, for losses from sales or exchanges of property between related taxpayers.

(vi) *Alternative tax.* The tax shall be computed under this subparagraph without regard to the alternative tax imposed by section 1201 upon the excess of the net long-term capital gain over the net short-term capital loss.

(vii) *Allowance of losses.* In computing the tax under this subparagraph losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from sales or exchanges of capital assets.

(viii) *Gains not included.* The provisions of this subparagraph do not apply to amounts described in section 402 (a) (2), section 403(a)(2) for taxable years ending after September 2, 1958, section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets. See subparagraph (3) of this paragraph.

(5) *Deductions allowable.* For the allowance of deductions in computing the tax under this paragraph, see paragraph (b) (1) of § 1.873–1.

(6) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), by section 32 (relating to tax withheld at source on nonresident aliens), and for taxable years beginning before January 1, 1958, by section 35 (relating to partially tax-exempt interest) shall be allowed against the tax computed in accordance with this paragraph.

(c) *No United States business; gross income of more than $15,400*—(1) *Imposition of tax.* Except as otherwise provided by paragraph (e) of this section and subparagraph (4) of this paragraph, a nonresident alien individual within class 2 is, in accordance with the provisions of section 871 (b), subject to tax under section 1 or, in the alternative, under section 1201 (b) upon the income computed in accordance with this paragraph and received during the taxable year from sources within the United States. In computing the alternative tax under section 1201 (b) for this purpose, all amounts constituting, or considered to be, gains and losses from the sale or exchange of capital assets, whether described in paragraph (b) (3) or (4) of this section, shall be taken into account to the extent prescribed by subparagraphs (2) and (3) of this paragraph.

(2) *Gross income.* For the purposes of subparagraph (1) of this paragraph, the gross income shall include only those items of gains, profits, and income which would be taken into account if the tax were being determined in accordance with paragraph (b) of this section, that is, the gross amount of fixed or determinable annual or periodical income determined in accordance with paragraph (b) (2) of this section, the full amount of any gain taxable in accordance with paragraph (b) (3) of this section, and all other gains (computed without regard to any losses) which are to be taken into account in determining the tax under paragraph (b) (4) of this section. For such purposes, all such gains derived from the sale or exchange of capital assets, whether taken into account under paragraph (b) (3) or (4) of this section, shall be included to the same extent as provided by subchapter P (section 1201 and following), chapter 1 of the Code, and the regulations thereunder.

(3) *Deductions.* In computing, for purposes of subparagraph (1) of this paragraph, the income subject to tax under section 1 or section 1201 (b), there shall be allowed as deductions—

(i) *Capital losses.* Any loss, allocable to sources within the United States, from the sale or exchange of a capital asset which would be taken into account if the tax were being determined in accordance with paragraph (b) (4) of this section, except that such loss shall be allowed only to the extent provided by subchapter P (section 1201 and following), chapter 1 of the Code, and the regulations thereunder, but without the benefit of the capital loss carryover provided by section 1212;

(ii) *Charitable contributions.* The deduction for charitable contributions and gifts to the extent allowed by section 170, whether or not connected with income from sources within the United States, but (in accordance with section 873 (c)) only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States; and

(iii) *Other deductions.* Any other deduction (including the deduction allowed by section 1202 in respect of capital gains) allowed by section 873, but only if, and to the extent that, they are properly allocable to the gross income specified in subparagraph (2) of this paragraph. See also § 1.873–1.

(4) *Minimum tax*—(i) *Taxable years beginning before January 1, 1958.* Notwithstanding the provisions of subparagraph (1) of this paragraph, and except as otherwise provided by paragraph (e) of this section, the tax for a taxable year beginning before January 1, 1958, of a nonresident alien individual within class 2 shall in no case be less than 30 percent

of the aggregate of the amounts determined under paragraph (b) (2), (3), and (4) of this section and received during the taxable year from sources within the United States.

(ii) *Taxable years beginning after December 31, 1957.* Notwithstanding the provisions of subparagraph (1) of this paragraph, and except as otherwise provided by paragraph (e) of this section, if the tax for a taxable year beginning after December 31, 1957, of a nonresident alien individual within class 2 minus the sum of the credits under sections 34 and 35 would be an amount which is less than 30 percent of the aggregate of the amounts determined under paragraph (b) (2) (determined without regard to the section 116 exclusion), (3), and (4) of this section and received during the taxable year from sources within the United States, then this paragraph shall not apply but paragraph (b) of this section shall apply. The provisions of this subdivision may be illustrated by the following example:

Example. A nonresident alien individual during the taxable year 1959 receives from sources within the United States a total income consisting of $15,450 in dividends from a domestic corporation not disqualified by sections 34(c) and 116(b). He is not engaged in trade or business within the United States during the taxable year, and the United States has no tax convention with the country of which he is a resident. His tax for the taxable year is $4,635 computed as follows:

Gross income (for purposes of determining whether section 871(b) applies)		$15,450
Less: Section 116(a) exclusion		50
Gross income (for purposes of determining tax under section 1)		15,400
Less: Deduction for personal exemption		600
Taxable income		14,800
Tax computed under section 1		$4,636
Less: Dividends-received credit under section 34, that is, the smallest of the following:		
4 percent of dividends included in gross income ($15,400 x 4 percent)	$616	
The tax for the taxable year	4,636	
4 percent of taxable income for the taxable year ($14,800 x 4 percent)	592	592
Balance of tax		4,044
Minimum limitation under section 871(b) (30% of $15,450)		$4,635
Tax for the taxable year as imposed by section 871(a) and computed without the allowance of the dividends-received credit and exclusion		$4,635

(5) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 34 (relating to dividends received by individuals), and section 35 (relating to partially tax-exempt interest) shall be allowed against the tax computed in accordance with this paragraph, even though, for taxable years beginning before January 1, 1958, such tax is computed in accordance with subparagraph (4) (i) of this paragraph. For taxable years beginning after December 31, 1957, if, by reason of subparagraph (4) (ii) of this paragraph, paragraph (b) of this section applies, the credits under sections 34 and 35 are not allowed.

(d) *United States business*—(1) *Imposition of tax.* Except as otherwise provided by paragraph (e) of this section, a nonresident alien individual within class 3 is, in accordance with the provisions of section 871 (c), subject to tax under section 1 or, in the alternative, under section 1201 (b) upon his taxable income.

(2) *Taxable income.* For purposes of this paragraph, the taxable income includes only the taxable income from sources within the United States, determined in accordance with the provisions of section 63(a), part I (section 861 and following), subchapter N, chapter 1 of the Code, sections 872 and 873, and the regulations thereunder.

(3) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 34 (relating to dividends received by individuals), and section 35 (relating to partially tax-exempt interest) shall be allowed against the tax computed in accordance with this paragraph.

(4) *Inapplicable provisions.* The provisions of paragraphs (b) and (c) of this section have no application in determining the tax of a nonresident alien individual engaged in trade or business within the United States.

(e) *Treaty income*—(1) *Definitions.* For purposes of this paragraph, the term "treaty income" shall be construed to mean the gross income of a nonresident alien individual the tax on which is limited by tax convention. Thus, for example, the term would include dividends derived by such an individual from sources within the United States which, in accordance with a tax convention, are subject to United States tax at a rate not to exceed 15 percent. The term "nontreaty income" shall be construed, for such purposes, to mean the gross income of a nonresident alien individual other than treaty income. In either case the gross income shall be determined in accordance with §§ 1.872–1 and 1.872–2, except that the provisions of section 116 shall be disregarded when determining (i) whether the individual is within class 1 or class 2 for the purposes of paragraph (a) of this section, (ii) whether the partial tax under subparagraph (3) (i) of this paragraph shall be computed in accordance with section 871 (a) or (b), and (iii) the tax under subparagraph (3) (ii) of this paragraph upon the separate items of treaty income.

(2) *Application of $15,400 limitation.* Treaty income shall be taken into account in determining whether a nonresident alien individual not engaged in trade or business within the United States at any time during the taxable year is within class 1 or class 2 for the purposes of paragraph (a) of this section; however, the tax upon such income shall be separately computed to the extent required by subparagraph (3) of this paragraph.

(3) *Computation of tax.* If the gross income of a nonresident alien individual within class 1, 2, or 3 consists of both treaty and nontreaty income, the tax liability for the taxable year shall be the sum of the amounts determined in accordance with subdivisions (i) and (ii) of this subparagraph. In no case, however, may the tax liability so determined exceed the tax liability with respect to the taxpayer's entire gross income, determined in accordance with paragraph (b), (c), or (d) of this section as though the tax convention had not come into effect and without reference to the provisions of this paragraph. This subparagraph shall not be construed to deny the credits provided by sections 31, 32, and 6402.

(i) Compute a partial tax upon only the nontreaty income in accordance with section 871 (a), (b), or (c), whichever applies, as determined under paragraph (b), (c), or (d) of this section, and as though the tax convention had not come into effect. To the extent allowed by such paragraph, the credits allowed by sections 34 and 35 shall then be allowed against the tax so computed but only with respect to items included in the nontreaty income. For this purpose, the nontreaty income alone shall be used as a basis for determining whether the partial tax shall be computed in accordance with section 871 (a) or (b).

(ii) Compute a tax upon the gross amount of each separate item of treaty income at the reduced rate applicable to that item under the tax convention. Notwithstanding any other provision to the contrary, this tax shall be determined without the allowance of any deduction, credit (other than the credits provided by sections 31, 32, and 6402), or exclusion in respect of any item included in the treaty income.

(4) *Illustration.* The application of this paragraph may be illustrated by the following examples:

Example (1). (i) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1956 from sources within the United States total gross income of $125,000, consisting of the following items and computed by taking into account the exclusion granted by section 116 (a):

Oil royalties the tax on which is limited by the convention to a rate not to exceed 15 percent	$100,000
Interest the tax on which is limited by the convention to a rate not to exceed 5 percent	5,000
Dividends the tax on which is not limited by the convention	10,000
Rents the tax on which is not limited by the convention	10,000
Total gross income	125,000

The dividends are assumed to be paid by a domestic corporation not disqualified by section 34 (c) or 116 (b). There are no allowable deductions, other than the deductions allowed by sections 613 and 873 (d). The taxpayer has not engaged in trade or business within the United States or had a permanent establishment therein at any time during the taxable year. Although entitled to do so under the convention, the taxpayer does not elect to be taxed for the taxable year as though he did have a permanent establishment within the United States.

(ii) The tax liability for the taxable year is $21,792, computed as follows:

Nontreaty gross income		$20,000
Less: Deduction for personal exemption		600
Nontreaty taxable income		19,400
Tax computed under section 1 on nontreaty taxable income		$6,942
Minimum tax prescribed by section 871 (b) (3) upon nontreaty gross income ($20,000×30 percent)		$6,000
Tax for the taxable year upon nontreaty taxable income, as above		$6,942
Less: Credit under section 34 in respect of the nontreaty dividends received, that is, the smallest of the following:		
4 percent of the dividends included in nontreaty gross income ($10,000×4 percent)	$400	
The tax for the taxable year upon nontreaty taxable income, as above	6,942	
4 percent of the nontreaty taxable income for the taxable year ($19,400×4 percent)	776	
		400
Partial tax computed in accordance with subparagraph (3) (i) of this paragraph		6,542
Plus: Tax on oil royalties ($100,000×15 percent)		15,000
Tax on interest ($5,000×5 percent)		250
Total		21,792

Under the facts of this example, for taxable years beginning after December 31, 1957, the minimum tax prescribed by section 871 upon nontreaty gross income shall be $6,015 ($20,050×30 percent).

Example (2). (i) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1955 from sources within the United States total gross income of $4,050, consisting of the following items and computed without regard to the exclusion granted by section 116 (a):

Dividends the tax on which is limited by the convention to a rate not to exceed 15 percent	$3,050
Compensation for personal services, the tax on which is not limited by the convention	1,000
Total gross income	4,050

The dividends are assumed to be paid by a domestic corporation not disqualified by section 34 (c) or 116 (b). The taxpayer was engaged in trade or business within the United States during the taxable year, but did not have a permanent establishment therein. Interest expense in the amount of $2,100 connected with the dividend income was paid by the taxpayer during the taxable year.

(ii) The tax liability for the taxable year is $208, computed as follows:

Total gross income computed by taking into account the exclusion granted by section 116 (a)		$4,000
Less: Deduction for interest expense paid	$2,100	
Deduction for personal exemption	600	
		2,700
Taxable income		1,300
Tax computed under section 1 on taxable income		$260
Less: Credit under section 34 in respect of the dividends received, that is, the smallest of the following:		
4 percent of the dividends included in gross income ($3,000×4 percent)	$120	
The tax for the taxable year, as above	260	
4 percent of taxable income for the taxable year ($1,300×4 percent)	52	
		52
Balance		208

Example (3). (i) A nonresident alien individual who is a resident of a foreign country with which the United States has entered into a tax convention receives during the taxable year 1955 from sources within the United States total gross income of $22,000, consisting of the following items:

Compensation for personal services, the tax on which is not limited by the convention	$20,000
Oil royalties the tax on which is limited by the convention to a rate not to exceed 15 percent	2,000
Total gross income	22,000

The taxpayer was engaged in trade or business within the United States during the taxable year but did not have a permanent establishment therein. Although entitled to do so under the convention, the taxpayer does not elect to be taxed for the taxable year as though he did have a permanent establishment within the United States. There are no allowable deductions, other than the deductions allowed by sections 613 and 873 (d).

(ii) The tax liability for the taxable year is $7,242, computed as follows:

Nontreaty gross income		$20,000
Less: Deduction for personal exemption		600
Nontreaty taxable income		19,400
Tax computed under section 1 on nontreaty taxable income		$6,942
Plus: Tax on oil royalties ($2,000×15%		300
Total		7,242

(5) *Exceptions.* This paragraph shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year or to a nonresident alien individual who, in accordance with a tax convention, is entitled, and does elect, to be subject to tax on a net basis as though he were engaged in trade or business within the United States through a permanent establishment situated therein. See paragraph (b) (3) of § 1.873–1 and § 1.876–1.

§ 1.871–8 Definition of engaging in trade or business within the United States.

(a) *Personal services.* As used in part I (section 861 and following), subchapter N, chapter 1 of the Code; sections 871, 881, 882; and chapter 3 (section 1441 and following) of the Code, and the regulations thereunder, the term "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year, but does not include the performance of personal services, (1) for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or (2) for an office or place of business maintained by a domestic corporation in a foreign country or in a possession of the United States, by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000. See section 7701 (a) (5) and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration) for the meaning of "foreign" when applied to a corporation or partnership. As to the source of compensation for personal services, see §§ 1.861–4 and 1.862–1.

(b) *Exchange transactions.* The term "engaged in trade or business within the United States" when used in the sections referred to in the first sentence of paragraph (a) of this section does not include the effecting of transactions in the United States in stocks or securities through a resident broker, commission agent, or custodian. Nor does it include the effecting of transactions in the United States in commodities (including hedging transactions) through such a person if (1) the goods are of a kind customarily dealt in on an organized commodity exchange, such as a grain futures or a cotton futures market; (2) the transaction is of the kind customarily consummated at such place; and (3) the alien, partnership, or corporation, by whom the transactions are effected, has no office or place of business in the United States at any time during the taxable year through which, or by the direction of which, such transactions in commodities are effected. For this purpose, the term "commodities" does not include merchandise in the ordinary channels of commerce. See paragraph (a) (3) of § 1.872–1.

(c) *Trusts.* Neither the beneficiary nor the grantor of a trust, whether revocable or irrevocable, is deemed to be engaged in trade or business within the United States merely because the trustee is engaged in trade or business within the United States.

§ 1.872 Statutory provisions; gross income.

SEC. 872. *Gross income*—(a) *General rule.* In the case of a nonresident alien individual gross income includes only the gross income from sources within the United States.

(b) *Exclusions.* The following items shall not be included in gross income of a nonresident alien individual, and shall be exempt from taxation under this subtitle:

(1) *Ships under foreign flag.* Earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

(2) *Aircraft of foreign registry.* Earnings derived from the operation of aircraft registered under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

§ 1.872–1 Gross income of nonresident alien individuals.

(a) *General*—(1) *United States sources.* The gross income of a nonresident alien individual includes only the gross income from sources within the United States. Except as may otherwise be provided by tax convention, the sources of the income for that purpose shall be determined in accordance with the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(2) *Change of status.* Income received by a resident alien from sources without the United States is taxable although he may become a nonresident alien subsequent to its receipt and before the close of the taxable year. Conversely, income received by a nonresident alien from sources without the United States is not taxable although he may become a resident alien subsequent to its receipt and before the close of the taxable year.

(3) *Exchange transactions.* Even though a nonresident alien individual may not be engaged in trade or business within the United States through the effecting of certain transactions in stocks, securities, or commodities, as described in paragraph (b) of § 1.871–8, nevertheless he shall be required to include in gross income the gains and profits from those transactions to the extent prescribed by § 1.871–7.

(4) *Sales or exchanges of property.* Amounts constituting, or considered to be, gains from the sale or exchange of capital assets, and profits derived from the sale within the United States of personal property, or from the sale of real property located therein, shall also be included in the gross income of a nonresident alien individual to the extent prescribed by § 1.871–7.

(5) *Exclusions.* For exclusions from gross income see § 1.872–2.

(b) *No United States business.* To determine the gross income of a nonresident alien individual who is not engaged in trade or business within the United States at any time during the taxable year, see paragraphs (b) and (c) of § 1.871–7. If that alien is also a bona fide resident of Puerto Rico during the entire taxable year, see § 1.876–1.

(c) *United States business.* To determine the gross income of a nonresident alien individual who at any time within the taxable year is engaged in trade or business within the United States, see paragraph (d) of § 1.871–7. If that alien is also a bona fide resident of Puerto Rico during the entire taxable year, see § 1.876–1.

§ 1.872–2 Exclusions from gross income of nonresident alien individuals.

(a) *Earnings of foreign ships or aircraft*—(1) *Basic rule.* So much of the income from sources within the United States of a nonresident alien individual as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption*—(i) *Ships.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(b) *Tax conventions.* Income of any kind which is exempt from United States tax under the provisions of a tax convention or treaty to which the United States is a party shall not be included in the gross income of a nonresident alien individual. Income on which the tax is limited by tax convention shall, however, be included in the gross income of such an individual if it is not otherwise excluded from gross income. See paragraph (e) of § 1.871–7 and § 1.894–1.

(c) *Other exclusions.* Income which is from sources without the United States, as determined under the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, or under the provisions of an applicable tax convention, shall not be included in the gross income of a nonresident alien individual. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Code.

§ 1.873 Statutory provisions; deductions.

SEC. 873. *Deductions*—(a) *General rule.* In the case of a nonresident alien individual the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary or his delegate.

(b) *Losses.* (1) The deduction, for losses not connected with the trade or business if incurred in transactions entered into for profit, allowed by section 165 (c) (2) (relating to losses) shall be allowed whether or not connected with income from sources within the United States, but only if the profit, if such transaction had resulted in a profit, would be taxable under this subtitle.

(2) The deduction for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 165 (c) (3), shall be allowed whether or not connected with income from sources within the United States, but only if the loss is of property within the United States.

(c) *Charitable contributions.* The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income from sources within the United States, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States.

(d) *Personal exemption.* In the case of a nonresident alien individual who is not a resident of a contiguous country, only one exemption under section 151 shall be allowed as a deduction.

(e) *Standard deduction.* For disallowance of standard deduction, see section 142 (b) (1).

§ 1.873–1 Deductions allowed nonresident alien individuals.

(a) *General provisions*—(1) *Allocation of deductions.* In computing the taxable income of a nonresident alien individual the deductions otherwise allowable shall be allowed only if, and to the extent that, they are connected with income from sources within the United States. No deduction shall be allowed in respect of any item, or portion thereof, which is not connected with income from such sources. For this purpose, the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, except as may otherwise be provided by tax convention. Thus, from the items of gross income specifically from sources within the United States and from the items allocated thereto under the provisions of section 863(a), there shall be deducted (i) the expenses, losses, and other deductions which are connected with those items of income and are properly apportioned or allocated thereto, and (ii) a ratable part of any other expenses, losses, or deductions which are connected with those items of income but cannot definitely be allocated to some item or class of gross income. The ratable part shall be based upon the ratio of gross income from sources within the United States to the total gross income. See §§ 1.861–8 and 1.863–1. In the case of income partly from within and partly from without the United States the expenses, losses, and other deductions connected with income from sources within the United States shall also be deducted in the manner prescribed by §§ 1.863–2 through 1.863–5 in order to ascertain under section 863 the portion of the taxable income attributable to sources within the United States.

(2) *Personal exemptions.* The deductions for the personal exemptions allowed by section 151 or 642 (b) shall not be taken into account for purposes of subparagraph (1) of this paragraph but shall be allowed to the extent provided by paragraphs (b) and (c) of this section.

(3) *Adjusted gross income.* The adjusted gross income of a nonresident alien individual shall be the gross income from sources within the United States, determined in accordance with § 1.871–7, minus the deductions prescribed by section 62 to the extent such deductions are allowed under this section in computing taxable income.

(4) *Standard deduction.* The standard deduction shall not be allowed in computing the taxable income of a nonresident alien individual. See section 142 (b) (1) and the regulations thereunder.

(5) *Exempt income.* No deduction shall be allowed under this section for the amount of any item or part thereof allocable to a class or classes of exempt income, including income exempt by tax convention. See section 265 and the regulations thereunder.

(b) *No United States business*—(1) *Income of not more than $15,400*—(i) *Deduction for losses only.* A nonresident alien individual within class 1 shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner prescribed by paragraph (b) (4) (vii) of § 1.871–7. Thus, an individual within this class shall not be allowed any deductions for the personal exemptions otherwise allowed by section 151 or 642 (b).

(ii) *Source of losses.* Notwithstanding the provisions of section 873 (b) (1), losses from sales or exchanges of capital assets shall be allowed under this subparagraph only if allocable to sources within the United States. See paragraph (b) (4) (i) of § 1.871–7.

(2) *Aggregate more than $15,400*—(i) *Deductions allowed.* In computing the income subject to tax under section 1 or section 1201 (b), a nonresident alien individual within class 2 shall be allowed deductions to the extent prescribed by paragraph (c) (3) of § 1.871–7, but subject to the limitations of this section. For this purpose, the deduction for the personal exemptions shall be allowed in accordance with subdivision (iii) of this subparagraph.

(ii) *Deductions disallowed.* In computing the minimum tax prescribed by section 871 (b) (3), that individual shall not be allowed any deductions other than the deduction for losses from sales or exchanges of capital assets determined in the manner precribed by paragraph (b) (4) (vii) of § 1.871–7. For this purpose, the deductions for the personal exemptions shall not be allowed. See paragraph (c) (4) of § 1.871–7.

(iii) *Personal exemptions.* When the deductions for personal exemptions are allowed under this subparagraph, only one exemption under section 151 shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642 (b) and the regulations thereunder.

(iv) *Source of losses.* Notwithstanding the provisions of section 873 (b), losses from sales or exchanges of capital assets shall be allowed under this subparagraph only if allocable to sources within the United States. See paragraph (c) (3) (i) of § 1.871–7.

(3) *Election to be taxed on a net basis.* Notwithstanding the other provisions of this paragraph, a nonresident alien individual within class 1 or 2 shall be allowed the deductions allowed by paragraph (c) of this section, if pursuant to a tax convention he is entitled, and does elect, to be subject to United States tax on a net basis as though he were engaged in trade or business within the United States through a permanent establishment situated therein.

(c) *United States business*—(1) *Deductions in general.* For purposes of computing the income subject to tax, a nonresident alien individual within class 3 shall be allowed deductions to the extent prescribed by paragraph (d) of § 1.871–7, but subject to the limitations of this section. For this purpose, the deductions for the personal exemptions shall be allowed in accordance with subparagraph (3) of this paragraph.

(2) *Special deductions.* Notwithstanding the rule of source prescribed in paragraph (a) of this section, an individual within class 3 shall be allowed the following deductions whether or not they are connected with income from sources within the United States:

(i) *Losses on transactions for profit.* Any loss sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with a trade or business, shall be allowed to the extent allowed by section 165 (c) (2), but only if and to the extent that the profit, if the transaction had resulted in a profit, would be taxable to such individual. Losses allowed under this subdivision shall be deducted in full, as provided in §§ 1.861–8 and 1.863–1, when the profit from the transaction, if it had resulted in a profit, would, under the provisions of section 861 (a) or 863 (a), have been taxable in full as income from sources within the United States; but shall be deducted under the provisions of § 1.863–3 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part.

(ii) *Casualty losses.* Any loss of property not connected with a trade or business, sustained during the taxable year and not compensated for by insurance or otherwise, if the loss arises from fire, storm, shipwreck, or other casualty, or from theft, shall be allowed to the extent allowed by section 165 (c) (3), but only if the loss is of property within the United States. Losses allowed under this subdivision shall be deducted in full, as provided in §§ 1.861–8 and 1.863–1, from the items of gross income specified under sections 861 (a) and 863 (a) as being derived in full from sources within the United States; but, if greater than the sum of those items, the unabsorbed loss shall be deducted from the income apportioned under the provisions of § 1.863–3 to sources within the United States.

(iii) *Charitable contributions.* The deduction for charitable contributions and gifts, to the extent allowed by section 170, shall be allowed under this subparagraph, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States.

(3) *Personal exemptions.* Only one exemption under section 151 shall be allowed in the case of an individual who is not a resident of Canada or Mexico. A resident of either of those countries shall be allowed all the exemptions granted by section 151 to the extent prescribed therein. An estate or trust, whether or not a resident of Canada or Mexico, shall determine its deduction for the personal exemption in accordance with section 642 (b) and the regulations thereunder.

§ 1.874 Statutory provisions; allowance of deductions and credits.

SEC. 874. *Allowance of deductions and credits*—(a) *Return prerequisite to allowance.* A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him in this subtitle only by filing or causing to be filed a true and accurate return of his total income received from all sources in the United States, in the manner prescribed in subtitle F (sec. 6001 and following, relating to procedure and administration), including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits. This subsection shall not be construed to deny the credits provided by sections 31 and 32 for tax withheld at the source.

(b) *Tax withheld at source.* The benefit of the deduction for exemptions under section 151 may, in the discretion of the Secretary or his delegate, and under regulations prescribed by the Secretary or his delegate, be received by a nonresident alien individual entitled thereto, by filing a claim therefor with the withholding agent.

(c) *Foreign tax credit not allowed.* A nonresident alien individual shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

§ 1.874–1 Allowances of deductions and credits to nonresident alien individuals.

(a) *Return required.* A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him with respect to the income tax, only if he files or causes to be filed with the district director (or, if applicable, with the Director of International Operations), in accordance with section 6012 and the regulations thereunder, a true and accurate return of his total income received from all sources within the United States. This paragraph shall not be construed, however, to deny the credits provided by sections 31 and 32.

(b) *Tax on gross income.* If a return is not so filed, the tax shall be collected on the basis of gross income, determined in accordance with § 1.871–7 but without regard to any deductions otherwise allowable, and the only credits allowable against the tax so computed shall be those allowed by sections 31 and 32. This paragraph shall apply even though the tax determined in accordance with § 1.871–7 has been fully satisfied at the

source. See also § 1.872–1. Notwithstanding the requirement that a nonresident alien must file a return in order to receive the benefit of the deductions and credits allowed to him with respect to the income tax, he may, for purposes of determining the amount of tax to be withheld under section 1441 from remuneration paid for labor or personal services performed by him within the United States, receive the benefit of the deduction of one personal exemption provided in section 151 by filing a claim therefor with the withholding agent. See section 873(d), relating to the number of personal exemptions allowed nonresident aliens. The amount of the deduction for such personal exemption and the amount of the tax to be withheld under such circumstances shall be determined in accordance with paragraph (e)(2) of § 1.1441–3.

(c) *Return by district director.* If a nonresident alien individual has various sources of income within the United States, so that from any one source, or from all sources combined, the amount of income shall call for the assessment of a tax greater than that withheld at the source in the case of that individual, and a return of income has not been filed by him or on his behalf, the district director (or, if applicable, the Director of International Operations) shall (1) cause a return of income to be made, (2) include therein the income described in § 1.871–7 of that individual from all sources concerning which he has information, and (3) assess the tax and collect it from one or more of those sources of income within the United States, without allowance for deductions or credits (other than the credits provided by sections 31 and 32).

(d) *Alien resident of Puerto Rico.* This section shall not apply to a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year. See § 1.876–1.

§ 1.875 Statutory provisions; partnerships.

SEC. 875. *Partnerships.* For purposes of this subtitle, a nonresident alien individual shall be considered as being engaged in a trade or business within the United States if the partnership of which he is a member is so engaged.

§ 1.875–1 Partnerships.

Whether a nonresident alien individual who is a member of a partnership is taxable in accordance with subsection (a), (b), or (c) of section 871 may depend on the status of the partnership. A nonresident alien individual who is a member of a partnership which is not engaged in trade or business within the United States is subject to the provisions of section 871 (a) or (b), as the case may be, depending on whether or not he receives during the taxable year an aggregate of more than $15,400 gross income described in section 871 (a), if he is not otherwise engaged in trade or business within the United States. A nonresident alien individual who is a member of a partnership which at any time within the taxable year is engaged in trade or business within the United States is considered as being engaged in trade or business within the United States and is therefore taxable under section 871 (c). For definition of what the term "partnership" includes, see section 7701 (a) (2) and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration). The test of whether a partnership is engaged in trade or business within the United States is the same as in the case of a nonresident alien individual. See § 1.871–8.

§ 1.876 Statutory provisions; alien residents of Puerto Rico.

SEC. 876. *Alien residents of Puerto Rico—*

(a) *No application to certain alien residents of Puerto Rico.* This subpart shall not apply to an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, and such alien shall be subject to the tax imposed by section 1.

(b) *Cross reference.* For exclusion from gross income of income derived from sources within Puerto Rico, see section 933.

§ 1.876–1 Alien residents of Puerto Rico.

(a) *General.* A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, in accordance with the provisions of section 876, subject to tax under section 1 or, in the alternative, under section 1201 (b) in generally the same manner as in the case of an alien resident of the United States. See paragraph (b) of § 1.1–1 and § 1.871–1. The tax is imposed upon the taxable income of such a resident of Puerto Rico, determined in accordance with section 63 (a) and the regulations thereunder, from sources both within and without the United States, except that under the provisions of section 933 income derived from sources within Puerto Rico (other than amounts received for services performed as an employee of the United States or any agency thereof) is excluded from gross income. For determining the form of return to be used by such an individual, see section 6012 and the regulations thereunder.

(b) *Exceptions.* Though subject to the tax imposed by section 1, a nonresident alien individual who is a bona fide resident of Puerto Rico during his entire taxable year shall nevertheless be treated as a nonresident alien for the purpose of many provisions of the Code relating to nonresident alien individuals. Thus, for example, such a resident of Puerto Rico is not allowed to compute his tax in accordance with the optional tax table (section 4(d)(1)); is not allowed the standard deduction (section 142(b)(1)); is not allowed a deduction for a "dependent" who is a resident of Puerto Rico unless the dependent is a citizen of the United States (section 152(b)(3)); is subject to withholding of tax at source under chapter 3 of the Code (sections 1441 (d) and 1451 (e)); is generally not subject to the collection of income tax at source on wages (section 3401 (a) (6)); is not allowed to make a joint return or a joint declaration of estimated tax (sections 6013 (a) (1) and 6015 (b)); must pay his estimated tax on or before the 15th day of the fourth month of the taxable year (sections 6015 (a), 6073 (a), and 6153 (a) (1)); and must pay his income tax on or before the 15th day of the sixth month following the close of the taxable year (sections 6072 (c) and 6151 (a)).

(c) *Credits against tax.* The credits allowed by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens), section 33 (relating to taxes of foreign countries), section 34 (relating to dividends received by individuals), and section 35 (relating to partially tax-exempt interest) shall be allowed against the tax computed in accordance with this section. No credit shall be allowed under section 37 in respect of retirement income.

§ 1.877 Statutory provisions; certain foreign exempt organizations.

SEC. 877. *Foreign educational, charitable, and certain other exempt organizations.* For special provisions relating to unrelated business income of foreign educational, charitable, and other exempt trusts, see section 512 (a).

FOREIGN CORPORATIONS

§ 1.881 Statutory provisions; tax on foreign corporations not engaged in business in the United States.

SEC. 881. *Tax on foreign corporations not engaged in business in United States—*(a) *Imposition of tax.* In the case of every foreign corporation not engaged in trade or business within the United States, there is hereby imposed for each taxable year, in lieu of the taxes imposed by section 11, a tax of 30 percent of the amount received from sources within the United States as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (including amounts described in section 631 (b) and (c) which are considerd to be gains from the sale or exchange of capital assets).

(b) *Doubling of tax.* For doubling of tax on corporations of certain foreign countries, see section 891.

§ 1.881–1 Taxation of foreign corporations.

(a) *Classes of foreign corporations.* For purposes of the income tax, foreign corporations are divided into two classes, namely, nonresident foreign corporations and resident foreign corporations. A nonresident foreign corporation is a foreign corporation which is not engaged in trade or business within the United States at any time during the taxable year. A resident foreign corporation is a foreign corporation which, at some time during the taxable year, is engaged in trade or business within the United States. See also section 7701 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

(b) *Manner of taxing.* A foreign corporation, whether resident or nonresident, is taxable only on income derived from sources within the United States, to the extent indicated in § 1.881–2 or § 1.882–1.

(c) *Meaning of terms.* For the meaning of the term "engaged in trade or business within the United States", as used in this section, see § 1.871–8. For the definition of the term "foreign corporation", see section 7701 (a) (3) and (5), and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

(d) *Corporations included as foreign.* The following corporations shall be included as foreign corporations for purposes of this section:

(1) A foreign life insurance company not carrying on an insurance business within the United States, as described in section 816 (b) (section 807 (b) in the case of taxable years beginning before January 1, 1955);

(2) A foreign mutual insurance company (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States, as described in section 821 (d); and

(3) A foreign insurance company (other than a life or mutual insurance company), a foreign mutual marine insurance company, and a foreign mutual fire insurance company, not carrying on an insurance business within the United States, as described in section 831 (b).

(e) *Other provisions applicable to foreign corporations*—(1) *Insurance companies.* For the taxation of foreign insurance companies carrying on an insurance business within the United States, see sections 816 (a) (section 807 (a) in the case of taxable years beginning before January 1, 1955), 822 (e), and 832 (d), and the regulations thereunder.

(2) *Accumulated earnings tax.* For the imposition of the accumulated earnings tax upon the accumulated taxable income of a foreign corporation, whether resident or nonresident, formed or availed of for tax avoidance purposes, see section 532 and the regulations thereunder.

(3) *Personal holding company tax.* For the imposition of the personal holding company tax upon the undistributed personal holding company income of a foreign corporation, whether resident or nonresident, see sections 541 and 545, and the regulations thereunder.

(4) *Foreign personal holding companies.* For the mandatory inclusion in the gross income of the United States shareholders of the undistributed foreign personal holding company income of a foreign personal holding company, see section 551 and the regulations thereunder.

§ 1.881–2 Tax on nonresident foreign corporations.

(a) *Imposition of tax.* Except as otherwise provided by paragraph (f) of this section, a nonresident foreign corporation is not subject to the tax imposed by section 11 or 1201(a) but, pursuant to the provisions of section 881(a), is liable to a flat tax of 30 percent upon the aggregate of the amounts determined under paragraphs (b) and (c) of this section and received during the taxable year from sources within the United States. For this purpose the source of the income shall be determined in accordance with the provisions of § 1.882–2. For the purposes of section 881(a), "amount received" means "gross income".

(b) *Fixed or determinable annual or periodical income.* The tax of 30 percent applies to the gross amount received as fixed or determinable annual or periodical gains, profits, and income. Specific items of fixed or determinable annual or periodical income are enumerated in section 881 (a) as interest (except interest on deposits with persons carrying on the banking business), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments, but other fixed or determinable annual or periodical gains, profits, and income are also subject to the tax as, for instance, royalties. As to the determination of fixed or determinable annual or periodical income, see paragraph (a) of § 1.1441–2. For special rules treating gain on the disposition of section 306 stock as fixed or determinable annual or periodical income, see section 306 (f) and the regulations thereunder.

(c) *Amounts considered to be capital gains.* The tax of 30 percent also applies, pursuant to the provisions of section 881 (a), to amounts received during the taxable year from sources within the United States which are described in section 631 (b) and (c) and are considered to be gains from the sale or exchange of capital assets. Thus, the tax applies to gain recognized under specified circumstances on the disposal of timber and coal and considered in accordance with section 1231 to be gain from the sale or exchange of a capital asset.

(d) *Losses and other deductions.* In computing the income subject to tax under this section no deduction shall be allowed for any loss sustained during the taxable year, even though the loss is taken into account under section 1231 in determining whether the gain is considered to be gain from the sale or exchange of a capital asset. For the general disallowance of deductions in computing the tax under this section, see paragraph (a) (1) of §.1.882–3.

(e) *Credit against tax.* The credit allowed by section 32 (relating to tax withheld at source on foreign corporations) shall be allowed against the tax computed in accordance with this section.

(f) *Treaty income.* If the gross income of a nonresident foreign corporation consists of both treaty and nontreaty income, the tax liability for the taxable year shall be determined in a manner consistent with that prescribed by paragraph (e) of § 1.871–7 in the case of a nonresident alien individual.

§ 1.882 Statutory provisions; tax on resident foreign corporations.

SEC. 882. *Tax on resident foreign corporations*—(a) *Imposition of tax.* A foreign corporation engaged in trade or business within the United States shall be taxable as provided in section 11.

(b) *Gross income.* In the case of a foreign corporation, gross income includes only the gross income from sources within the United States.

(c) *Allowance of deductions and credits*—(1) *Deductions allowed only if return filed.* A foreign corporation shall receive the benefit of the deductions allowed to it in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return of its total income received from all sources in the United States, in the manner prescribed in subtitle F, including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions.

(2) *Allocation of deductions.* In the case of a foreign corporation the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary or his delegate.

(3) *Charitable contributions.* The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income from sources within the United States.

(4) *Foreign tax credit.* Foreign corporations shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(d) *Returns of tax by agent.* If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return required under section 6012 shall be made by the agent.

§ 1.882–1 Tax on resident foreign corporations.

(a) *General*—(1) *Imposition of tax.* Except as otherwise provided by subparagraph (7) of this paragraph, a resident foreign corporation is, in accordance with section 882(a), subject to tax as prescribed by paragraphs (b) and (c) of this section, or in the alternative, to the tax imposed by section 1201(a).

(2) *Taxable income.* For purposes of this section, the taxable income of a resident foreign corporation includes only the taxable income from sources within the United States, determined in accordance with the provisions of section 63(a); part I (section 861 and following), subchapter N, chapter 1 of the Code; sections 882 and 883, and the regulations thereunder.

(3) *Credit against tax.* The credit allowed by section 32 (relating to tax withheld at source on foreign corporations) shall be allowed against the tax computed in accordance with this section.

(4) *Changes in tax rate.* For provisions respecting the effect of any change in rate of tax during the taxable year, see section 21 and the regulations thereunder.

(5) *Declarations of estimated tax.* Every foreign corporation which for its taxable year expects to be subject to tax under this section shall make a declaration of estimated tax in accordance with the provisions of section 6016 and the regulations thereunder.

(6) *Consolidated returns.* Except in the case of certain corporations organized under the laws of Canada or Mexico and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, a foreign corporation is not an includible corporation for purposes of the privilege of making a consolidated return by an affiliated group of corporations. See paragraph (b) (1) and (3) of § 1.1502–2.

under.

(7) *Treaty income.* If the gross income of a resident foreign corporation consists of both treaty and nontreaty income, the tax liability for the taxable year shall be determined in a manner consistent with that prescribed by paragraph (e) of § 1.871–7 in the case of a nonresident alien individual.

(b) *Normal tax.* A resident foreign corporation is liable to the normal tax imposed by section 11 (b). See that section and the regulations thereunder.

(c) *Surtax.* A resident foreign corporation is also liable to the surtax imposed by section 11 (c). See that section and the regulations thereunder.

§ 1.882–2 Gross income of foreign corporations.

(a) *United States sources.* The gross income of a foreign corporation, whether resident or nonresident, includes only the gross income from sources within the United States. Except as may otherwise be provided by tax convention, the sources of the income for that purpose shall be determined in accordance with the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(b) *Nonresident foreign corporations.* The gross income of a nonresident foreign corporation consists only of the items of income specified in section 881 (a) and described in § 1.881–2.

(c) *Resident foreign corporations—*(1) *Gross income not limited to specified items.* The gross income of a resident foreign corporation is not limited to the items of income specified in section 881 (a) but includes every item of gross income which, in accordance with paragraph (a) of this section, is treated as gross income from sources within the United States. See also paragraph (a) (2) of § 1.882–1.

(2) *Income from sale of property.* The gross income of a resident foreign corporation shall, subject to the provisions of paragraph (a) of this section, include gains derived from the sale or exchange of capital assets, gains from hedging transactions, and profits derived from the sale within the United States of personal property or from the sale of real property located therein.

(3) *Exchange transactions.* Even though a foreign corporation may not be engaged in trade or business within the United States through the effecting of certain transactions in stocks, securities, or commodities, as described in paragraph (b) of § 1.871–8, nevertheless, it shall, subject to the provisions of paragraph (a) of this section, be required to include in gross income the gains and profits from those transactions if at any time during the taxable year it has otherwise engaged in trade or business within the United States.

(d) *Exclusions.* For exclusions from gross income see § 1.883–1.

§ 1.882–3 Deductions allowed foreign corporations.

(a) *Nonresident foreign corporations—*(1) *General.* For purposes of computing the tax imposed by section 881(a) and described in § 1.881–2, a nonresident foreign corporation shall not be allowed any deductions, since the tax is imposed upon the gross amount received from sources within the United States.

(2) *Election to be taxed on a net basis.* Notwithstanding the provisions of subparagraph (1) of this paragraph, a nonresident foreign corporation shall be allowed the deductions allowed by paragraph (b) of this section, if pursuant to a tax convention it is entitled, and does elect, to be subject to United States tax on a net basis as though it were engaged in trade or business within the United States through a permanent establishment situated therein.

(b) *Resident foreign corporations—*(1) *General.* For purposes of computing the income subject to tax, a resident foreign corporation shall be allowed deductions to the extent prescribed by paragraph (a) (2) of § 1.882–1, but subject to the limitations of this paragraph.

(2) *Allocation of deductions.* In computing the taxable income of a resident foreign corporation the deductions otherwise allowable shall be allowed only if, and to the extent that, they are connected with income from sources within the United States. For this purpose, the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined in the same manner as provided in paragraph (a) (1) of § 1.873–1 with respect to nonresident alien individuals.

(3) *Special deductions.* The special deductions allowed by section 241 (relating to the deductions for partially tax-exempt interest, dividends received, etc.) in the case of a corporation shall be taken into account for purposes of subparagraph (2) of this paragraph. Thus, these deductions shall be allowed only in respect of amounts included in gross income pursuant to § 1.882–2.

(4) *Exempt income.* No deduction shall be allowed under this paragraph for the amount of any item or part thereof allocable to a class or classes of exempt income, including income exempt by tax convention. See section 265 and the regulations thereunder.

(5) *Charitable contributions.* Notwithstanding the rule of source prescribed in subparagraph (2) of this paragraph, a resident foreign corporation shall be allowed the deduction for charitable contributions and gifts, to the extent allowed by section 170, whether or not the deduction is connected with income from sources within the United States.

§ 1.882–4 Allowance of deductions to foreign corporations.

(a) *Nonresident foreign corporations.* As indicated in § 1.882–3, a nonresident foreign corporation is not allowed any deductions, whether or not a return of income is filed. The deductions allowed such a corporation electing under a tax convention to be subject to tax on a net basis shall be obtained by filing a return of income in the manner prescribed in the regulations under the tax convention. See paragraph (a) (2) of § 1.882–3.

(b) *Resident foreign corporations—*(1) *Return necessary.* A resident foreign corporation shall receive the benefit of the deductions allowed to it with respect to the income tax, only if it files or causes to be filed with the district director, in accordance with section 6012 and the regulations thereunder, a true and accurate return of its total income received from all sources within the United States.

(2) *Tax on gross income.* If a return is not so filed, the tax shall be collected on the basis of gross income, determined in accordance with § 1.882–1 but without regard to any deductions otherwise allowable.

(3) *Return by district director.* If a resident foreign corporation has various sources of income within the United States and a return of income has not been filed by it or on its behalf, the district director shall (i) cause a return of income to be made, (ii) include therein the income described in § 1.882–1 of that corporation from all sources concerning which he has information, and (iii) assess the tax and collect it from one or more of those sources of income within the United States, without allowance for any deductions.

§ 1.883 Statutory provisions; exclusions from gross income.

SEC. 883. *Exclusions from gross income.* The following items shall not be included in gross income of a foreign corporation, and shall be exempt from taxation under this subtitle:

(1) *Ships under foreign flag.* Earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

(2) *Aircraft of foreign registry.* Earnings derived from the operation of aircraft registered under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

§ 1.883–1 Exclusions from gross income of foreign corporations.

(a) *Earnings of foreign ships or aircraft—*(1) *Basic rule.* So much of the income from sources within the United States of a foreign corporation as consists of earnings derived from the operation of a ship or ships documented, or of aircraft registered, under the laws of a foreign country which grants an equivalent exemption to citizens of the United States nonresident in that foreign country and to corporations organized in the United States shall not be included in gross income.

(2) *Equivalent exemption—*(i) *Ships.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of a foreign ship or ships.

(ii) *Aircraft.* A foreign country which either imposes no income tax, or, in imposing that tax, exempts from taxation so much of the income of a citizen of

the United States nonresident in that foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of aircraft registered under the laws of the United States is considered as granting an equivalent exemption for purposes of the exclusion from gross income of the earnings of foreign aircraft.

(b) *Tax conventions.* Income of any kind which is exempt from United States tax under the provisions of a tax convention or treaty to which the United States is a party shall not be included in the gross income of a foreign corporation. Income on which the tax is limited by tax convention shall, however, be included in the gross income of such a corporation if it is not otherwise excluded from gross income. See paragraph (f) of § 1.881–2, paragraph (a) (7) of § 1.882–1, and § 1.894–1.

(c) *Other exclusions.* Income which is from sources without the United States, as determined under the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, or under the provisions of an applicable tax convention, shall not be included in the gross income of a foreign corporation. To determine specific exclusions in the case of other items which are from sources within the United States, see the applicable sections of the Code.

§ 1.884 Statutory provisions; cross references.

SEC. 884. *Cross references.* (1) For withholding at source of tax on income of foreign corporations, see section 1442.

(2) For rules applicable in determining whether any foreign corporation is engaged in trade or business within the United States, see section 871 (c).

(3) For special provisions relating to foreign insurance companies, see subchapter L (sec. 801 and following).

(4) For special provisions relating to unrelated business income of foreign educational, charitable, and certain other exempt organizations, see section 512 (a).

MISCELLANEOUS PROVISIONS

§ 1.891 Statutory provisions; doubling of rates of tax on citizens and corporations of certain foreign countries.

SEC. 891. *Doubling of rates of tax on citizens and corporations of certain foreign countries.* Whenever the President finds that, under the laws of any foreign country, citizens or corporations of the United States are being subjected to discriminatory or extraterritorial taxes, the President shall so proclaim and the rates of tax imposed by sections 1, 3, 11, 802, 811, 821, 831, 852, 871, and 881 shall, for the taxable year during which such proclamation is made and for each taxable year thereafter, be doubled in the case of each citizen and corporation of such foreign country; but the tax at such doubled rate shall be considered as imposed by such sections as the case may be. In no case shall this section operate to increase the taxes imposed by such sections (computed without regard to this section) to an amount in excess of 80 percent of the taxable income of the taxpayer (computed without regard to the deductions allowable under section 151 and under part VIII of subchapter B). Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under the preceding provisions of this section have been modified so that discriminatory and extraterritorial taxes applicable to citizens and corporations of the United States have been removed, he shall so proclaim, and the provisions of this section providing for doubled rates of tax shall not apply to any citizen or corporation of such foreign country with respect to any taxable year beginning after such proclamation is made.

[Sec. 891 as amended by sec. 5(6), Life Insurance Company Tax Act 1955 (70 Stat. 49)]

§ 1.892 Statutory provisions; income of foreign governments and of international organizations.

SEC. 892. *Income of foreign governments and of international organizations.* The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

§ 1.892–1 Income of foreign governments and international organizations.

(a) *Foreign governments.* The exemption of the income of foreign governments applies also to their political subdivisions. Any income collected by foreign governments from investments in the United States in stocks, bonds, or other domestic securities which are not actually owned by, but are loaned to, such foreign governments is subject to tax.

(b) *International organizations—(1) Exempt from tax.* Subject to the provisions of section 1 of the International Organizations Immunities Act (22 U.S.C. 288) (the provisions of which section are set forth in paragraph (b) (3) of § 1.893–1), the income of an international organization (as defined in section 7701(a) (18)) received from investments in the United States in stocks, bonds, or other domestic securities, owned by such international organization, or from interest on deposits in banks in the United States of moneys belonging to such international organization, or from any other source within the United States, is exempt from Federal income tax.

(2) *Income received prior to Presidential designation.* An organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act may enjoy the benefits of the exemption with respect to income of the prescribed character received by such organization prior to the date of the issuance of such Executive order, if (i) the Executive order does not provide otherwise and (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time such income is received.

§ 1.893 Statutory provisions; compensation of employees of foreign governments or international organizations.

SEC. 893. *Compensation of employees of foreign governments or international organizations*—(a) *Rule for exclusion.* Wages, fees, or salary of any employee of a foreign government or of an international organization (including a consular or other officer, or a nondiplomatic representative), received as compensation for official services to such government or international organization shall not be included in gross income and shall be exempt from taxation under this subtitle if—

(1) Such employee is not a citizen of the United States, or is a citizen of the Republic of the Philippines (whether or not a citizen of the United States); and

(2) In the case of an employee of a foreign government, the services are of a character similar to those performed by employees of the Government of the United States in foreign countries; and

(3) In the case of an employee of a foreign government, the foreign government grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country.

(b) *Certificate by Secretary of State.* The Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

§ 1.893–1 Compensation of employees of foreign governments or international organizations.

(a) *Employees of foreign governments—(1) Exempt from tax.* Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)), all employees of a foreign government (including consular or other officers, or nondiplomatic representatives) who are not citizens of the United States, or are citizens of the Republic of the Philippines (whether or not citizens of the United States), are exempt from Federal income tax with respect to wages, fees, or salaries received by them as compensation for official services rendered to such foreign government, provided (i) the services are of a character similar to those performed by employees of the Government of the United States in that foreign country and (ii) the foreign government whose employees are claiming exemption grants an equivalent exemption to employees of the Government of the United States performing similar services in that foreign country.

(2) *Certificate by Secretary of State.* Section 893 (b) provides that the Secretary of State shall certify to the Secretary of the Treasury the names of the foreign countries which grant an equivalent exemption to the employees of the Government of the United States performing services in such foreign countries, and the character of the services performed by employees of the Government of the United States in foreign countries.

(3) *Items not exempt.* The income received by employees of foreign governments from sources other than their

citizens or corporations of the United States tax.

salaries, fees, or wages, referred to in subparagraph (1) of this paragraph, is subject to Federal income tax.

(4) *Immigration and Nationality Act.* Section 247 (b) of the Immigration and Nationality Act provides as follows:

Sec. 247. Adjustment of status of certain resident aliens. * * *

(b) The adjustment of status required by subsection (a) [of section 247 of the Immigration and Nationality Act] shall not be applicable in the case of any alien who requests that he be permitted to retain his status as an immigrant and who, in such form as the Attorney General may require, executes and files with the Attorney General a written waiver of all rights, privileges, exemptions, and immunities under any law or any executive order which would otherwise accrue to him because of the acquisition of an occupational status entitling him to a nonimmigrant status under paragraph (15) (A), (15) (E), or (15) (G) of section 101 (a).

(5) *Effect of waiver.* An employee of a foreign government who executes and files with the Attorney General the waiver provided for in section 247 (b) of the Immigration and Nationality Act thereby waives the exemption conferred by section 893 of the Code. As a consequence, that exemption does not apply to income received by that alien after the date of filing of the waiver.

(6) *Citizens of the United States.* The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of a foreign government is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(b) *Employees of international organizations*—(1) *Exempt from tax.* Except to the extent that the exemption is limited by the execution and filing of the waiver provided for in section 247 (b) of the Immigration and Nationality Act and subject to the provisions of sections 7, 8, and 9 of the International Organizations Immunities Act (22 U.S.C. 288, 288e, 288f), wages, fees, or salary of any officer or employee of an international organization (as defined in section 7701 (a)(18)) received as compensation for official services to that international organization is exempt from Federal income tax, if that officer or employee (i) is not a citizen of the United States or (ii) is a citizen of the Republic of the Philippines (whether or not a citizen of the United States).

(2) *Income earned prior to executive action.* An individual of the prescribed class who receives wages, fees, or salary as compensation for official services to an organization designated by the President through appropriate Executive order as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act and who has been duly notified to, and accepted by, the Secretary of State as an officer or employee of that organization, or who has been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective officer or employee of that organization, may enjoy the benefits of the exemption with respect to compensation of the prescribed character earned by that individual, either prior to the date of the issuance of the Executive order, or prior to the date of the acceptance or designation by the Secretary of State, for official services to that organization, if (i) the Executive order does not provide otherwise, (ii) the organization is a public international organization in which the United States participates, pursuant to a treaty or under the authority of an act of Congress authorizing such participation or making an appropriation for such participation, at the time the compensation is earned, and (iii) the individual is an officer or employee of that organization at that time.

(3) *International Organizations Immunities Act.* Sections 1, 8, and 9 of the International Organizations Immunities Act (22 U.S.C. 288, 288e, 288f) provide in part as follows:

SECTION 1. For the purposes of this title [International Organizations Immunities Act], the term "international organization" means a public international organization in which the United States participates pursuant to any treaty or under the authority of any Act of Congress authorizing such participation or making an appropriation for such participation, and which shall have been designated by the President through appropriate Executive order as being entitled to enjoy the privileges, exemptions, and immunities herein provided. The President shall be authorized, in the light of the functions performed by any such international organization, by appropriate Executive order to withhold or withdraw from any such organization or its officers or employees any of the privileges, exemptions, and immunities provided for in this title (including the amendments made by this title) or to condition or limit the enjoyment by any such organization or its officers or employees of any such privilege, exemption, or immunity. The President shall be authorized, if in his judgment such action should be justified by reason of the abuse by an international organization or its officers and employees of the privileges, exemptions, and immunities herein provided or for any other reason, at any time to revoke the designation of any international organization under this section, whereupon the international organization in question shall cease to be classed as an international organization for the purposes of this title.

* * * * *

SEC. 8. (a) No person shall be entitled to the benefits of this title [International Organizations Immunities Act] unless he (1) shall have been duly notified to and accepted by the Secretary of State as a * * * officer, or employee; or (2) shall have been designated by the Secretary of State, prior to formal notification and acceptance, as a prospective * * * officer, or employee; * * *.

(b) Should the Secretary of State determine that the continued presence in the United States of any person entitled to the benefits of this title is not desirable, he shall so inform the * * * international organization concerned * * *, and after such person shall have had a reasonable length of time, to be determined by the Secretary of State, to depart from the United States, he shall cease to be entitled to such benefits.

(c) No person shall, by reason of the provisions of this title, be considered as receiving diplomatic status or as receiving any of the privileges incident thereto other than such as are specifically set forth herein.

SEC. 9. The privileges, exemptions, and immunities of international organizations and of their officers and employees * * * provided for in this title [International Organizations Immunities Act], shall be granted notwithstanding the fact that the similar privileges, exemptions, and immunities granted to a foreign government, its officers, or employees, may be conditioned upon the existence of reciprocity by that foreign government: *Provided*, That nothing contained in this title shall be construed as precluding the Secretary of State from withdrawing the privileges, exemptions, and immunities herein provided from persons who are nationals of any foreign country on the ground that such country is failing to accord corresponding privileges, exemptions, and immunities to citizens of the United States.

(4) *Effect of waiver.* An officer or employee of an international organization who executes and files with the Attorney General the waiver provided for in section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)) thereby waives the exemption conferred by section 893 of the Code. As a consequence, that exemption does not apply to income received by that individual after the date of filing of the waiver.

(5) *Citizens of the United States.* The compensation of citizens of the United States (other than those who are also citizens of the Republic of the Philippines) who are officers or employees of an international organization is not exempt from income tax pursuant to this paragraph. But see section 911 and the regulations thereunder.

(c) *Tax conventions, consular conventions, and international agreements*—(1) *Exemption dependent upon internal revenue laws.* A tax convention or consular convention between the United States and a foreign country, which provides that the United States may include in the tax base of its residents all income taxable under the internal revenue laws, and which makes no specific exception for the income of the employees of that foreign government, does not provide any exemption (with respect to residents of the United States) beyond that which is provided by the internal revenue laws. Accordingly, the effect of the execution and filing of a waiver under section 247 (b) of the Immigration and Nationality Act by an employee of a foreign government which is a party to such a convention is to subject the employee to tax to the same extent as provided in paragraph (a) (5) of this section with respect to the waiver of exemption under section 893.

(2) *Exemption not dependent upon internal revenue laws.* If a tax convention, consular convention, or international agreement provides that compensation paid by the foreign government or international organization to its employees is exempt from Federal income tax, and the application of this exemption is not dependent upon the provisions of the internal revenue laws, the exemption so conferred is not affected by the execution and filing of a waiver under section 247 (b) of the Immigration and Nationality Act. For examples of exemptions which are not affected by the Immigration and Nationality Act, see article X of the income tax convention between the United States and the United Kingdom (60 Stat. 1383); article

IX, section 9 (b), of the Articles of Agreement of the International Monetary Fund (60 Stat. 1414); and article VII, section 9 (b), of the Articles of Agreement of the International Bank for Reconstruction and Development (60 Stat. 1458).

§ 1.894 Statutory provisions; income exempt under treaty.

SEC. 894. *Income exempt under treaty.* Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

§ 1.894–1 Income exempt under treaty.

Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from income tax. A tax convention shall be considered as a treaty for this purpose. See paragraph (e) of § 1.871–7, paragraph (f) of § 1.881–2, or paragraph (a) (7) of § 1.882–1 for the manner of computing the tax liability of a nonresident alien individual or foreign corporation whose gross income includes income on which the tax is limited by tax convention.

INCOME FROM SOURCES WITHOUT THE UNITED STATES

FOREIGN TAX CREDIT

§ 1.901 Statutory provisions; taxes of foreign countries and of possessions of United States.

SEC. 901. *Taxes of foreign countries and of possessions of United States*—(a) *Allowance of credit.* If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under section 902. Such choice may be made or changed at any time prior to the expiration of the period prescribed for making a claim for credit or refund of the tax against which the credit is allowable. The credit shall not be allowed against the tax imposed by section 531 (relating to the tax on accumulated earnings), against the additional tax imposed for the taxable year under section 1333 (relating to war loss recoveries), or against the personal holding company tax imposed by section 541.

(b) *Amount allowed.* Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) *Citizens and domestic corporations.* In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) *Resident of the United States or Puerto Rico.* In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) *Alien resident of the United States or Puerto Rico.* In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) *Partnerships and estates.* In the case of any individual described in paragraph (1), (2), or (3), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(c) *Corporations treated as foreign.* For purposes of this subpart, the following corporations shall be treated as foreign corporations:

(1) A corporation entitled to the benefits of section 931, by reason of receiving a large percentage of its gross income from sources within a possession of the United States; and

(2) A corporation organized under the China Trade Act, 1922 (15 U. S. C., chapter 4), and entitled to the deduction provided in section 941.

(d) *Cross reference.* (1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see section 164.

(2) For right of each partner to make election under this section, see section 703 (b).

(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642 (a) (2).

§ 1.901–1 Allowance of credit for taxes.

(a) *In general.* Citizens of the United States, domestic corporations, and certain aliens resident in the United States or Puerto Rico may choose to claim a credit, as provided in section 901, against the tax imposed by chapter 1 of the Code for taxes paid or accrued to foreign countries and possessions of the United States, subject to the conditions prescribed in the following subparagraphs:

(1) *Citizen of the United States.* A citizen of the United States, whether resident or nonresident, may claim a credit for (i) the amount of any income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued under section 905(b)) during the taxable year to any foreign country or to any possession of the United States; and (ii) his share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary.

(2) *Domestic corporation.* A domestic corporation may claim a credit for (i) the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and (ii) the taxes deemed to have been paid or accrued under section 902 or 905(b).

(3) *Alien resident of the United States or Puerto Rico.* An alien resident of the United States, or an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, may claim a credit for—

(i) The amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any possession of the United States;

(ii) The amount of any such taxes paid or accrued (or deemed paid or accrued under section 905(b)) during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(iii) His share of any such taxes of a partnership of which he is a member, or of an estate or trust of which he is a beneficiary, paid or accrued (or deemed paid or accrued under section 905(b)) during the taxable year,

(*a*) To any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country, or

(*b*) To any possession of the United States, as the case may be.

(b) *Foreign countries which satisfy the similar credit requirement*—(1) *Taxes of foreign country of which alien resident is citizen or subject.* A foreign country of which an alien resident is a citizen or subject allows a similar credit, within the meaning of section 901 (b) (3), to a United States citizen residing in such country either—

(i) If such country allows him a credit against its income taxes for the amount of income taxes paid or accrued to the United States; or

(ii) If, in imposing such taxes, such country exempts from taxation the income received by him from sources within the United States (as determined under Part I (section 861 and following), subchapter N, chapter 1 of the Code).

(2) *Taxes of foreign country other than one of which alien resident is citizen or subject.* An alien resident of the United States may claim a credit for income taxes paid or accrued by him to a foreign country other than the one of which he is a citizen or subject if the country of which he is a citizen or subject either—

(i) Allows a credit to a United States citizen residing therein for income taxes paid or accrued by him to such other foreign country; or

(ii) In imposing its income taxes, exempts from taxation the income of a United States citizen residing therein from sources within such other foreign country.

(c) *Deduction denied if credit claimed.* If a taxpayer chooses with respect to any taxable year to claim a credit for taxes to any extent, such choice will be considered to apply to income, war profits, and excess profits taxes paid or accrued in such taxable year to all foreign countries and possessions of the United States, and no portion of any such taxes shall be allowed as a deduction from gross income in such taxable year or any succeeding taxable year. See section 164 (b) (6).

(d) *Period during which election can be made or changed.* The taxpayer may, with respect to a particular taxable year, claim the benefits of section 901 (or change such choice if previously made) at any time prior to the expiration of the period prescribed for making a claim for credit or refund of the tax against which the credit is allowable. See section 6511 (a) and (d) (3).

(e) *Joint return.* In the case of a husband and wife making a joint return, credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be computed upon the basis of the total taxes so paid by or accrued against the spouses.

(f) *Taxes against which credit not allowed.* The credit for taxes shall be allowed only against the tax imposed by chapter 1 of the Code, but it shall not be allowed against the following taxes imposed under that chapter:

(1) The tax on accumulated earnings imposed by section 531;

(2) The personal holding company tax imposed by section 541; and

(3) The additional tax relating to war loss recoveries imposed by section 1333.

(g) *Taxpayers to whom credit not allowed.* Among those to whom the credit for taxes is not allowed are the following:

(1) A foreign corporation (see section 882 (c) (4));

(2) A China Trade Act corporation (see section 942);

(3) A citizen or domestic corporation entitled to the benefits of the exemption provided by section 931 for income from possessions of the United States (see section 931 (g));

(4) A nonresident alien, other than an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year (see sections 874 (c) and 901 (b) (3));

(5) A citizen of a possession of the United States (except Puerto Rico) who is not otherwise a citizen of the United States and who is not a resident of the United States and persons who are inhabitants of the Virgin Islands (see section 932).

(h) *Taxpayers denied credit in a particular taxable year.* Taxpayers who are denied the credit for taxes for particular taxable years are the following:

(1) An individual who elects to pay the optional tax imposed by section 3, or one who elects under section 144 to take the standard deduction (see section 36);

(2) A taxpayer who elects to deduct taxes paid or accrued to any foreign country or possession of the United States (see section 164);

(3) A regulated investment company which has exercised the election under section 853.

§ 1.901–2 Definitions.

(a) The term "amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year" means taxes proper, paid or accrued during the taxable year on behalf of the taxpayer claiming credit. No credit is given for amounts representing interest or penalties.

(b) As used in subpart A (section 901 and following), part III, subchapter N, chapter 1 of the Code, the term "foreign country" means any foreign state or political subdivision thereof, or any foreign political entity, which levies and collects income, war profits, or excess profits taxes.

(c) As used in subpart A (section 901 and following) of such part III, the term "any possession of the United States" includes Guam, Puerto Rico, and the Virgin Islands. But see section 931 and the regulations thereunder.

(d) The principles of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder shall apply in determining the sources of income for the purposes of subpart A (section 901 and following) of such part III.

(e) For definitions generally, see section 7701 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

§ 1.902 Statutory provisions; credit for corporate stockholder in foreign corporation.

SEC. 902. *Credit for corporate stockholder in foreign corporation*—(a) *Treatment of taxes paid by foreign corporation.* For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits.

(b) *Foreign subsidiary of foreign corporation.* If such foreign corporation owns 50 percent or more of the voting stock of another foreign corporation from which it receives dividends in any taxable year, it shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid by such other foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of the corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits.

(c) *Applicable rules.* (1) The term "accumulated profits," when used in this section in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income; and the Secretary or his delegate shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings.

(2) In the case of a foreign corporation, the income, war profits, and excess profits taxes of which are determined on the basis of an accounting period of less than 1 year, the word "year" as used in this subsection shall be construed to mean such accounting period.

(d) *Special rules for certain wholly-owned foreign corporations.* For purposes of this subtitle, if—

(1) A domestic corporation owns, directly or indirectly, 100 percent of all classes of outstanding stock of a foreign corporation engaged in manufacturing, production, or mining,

(2) Such domestic corporation receives property in the form of a royalty or compensation from such foreign corporation pursuant to any form of contractual arrangement under which the domestic corporation agrees to furnish services or property in consideration for the property so received, and

(3) Such contractual arrangement provides that the property so received by such domestic corporation shall be accepted by such domestic corporation in lieu of dividends and that such foreign corporation shall neither declare nor pay any dividends of any kind in any calendar year in which such property is paid to such domestic corporation by such foreign corporation,

then the excess of the fair market value of such property so received by such domestic corporation over the cost to such domestic corporation of the property and services so furnished by such domestic corporation shall be treated as a distribution by such foreign corporation to such domestic corporation, and for purposes of section 301, the amount of such distribution shall be such excess, in lieu of any amount otherwise determined under section 301 without regard to this subsection; and the basis of such property so received by such domestic corporation shall be the fair market value of such property, in lieu of the basis otherwise determined under section 301 (d) without regard to this subsection.

§ 1.902–1 Taxes of foreign corporation.

(a) *Domestic corporation owning stock of a foreign corporation.* (1) In the case of a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year, the credit for foreign taxes includes the income, war profits, and excess profits taxes deemed to have been paid by such domestic corporation. The amount of taxes so deemed to have been paid by the domestic corporation is determined by taking the same proportion of any income, war profits, and excess profits taxes paid or accrued to any foreign country or to any possession of the United States by such foreign corporation, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of any such dividends received bears to the amount of such accumulated profits. If dividends are received from more than one such foreign corporation, the taxes deemed to have been paid by the domestic corporation are computed separately for the dividends received from each such foreign corporation. If the credit for foreign taxes includes taxes deemed to have been paid, the taxpayer must furnish the same information with respect to such taxes as it is required to furnish with respect to the taxes actually paid or accrued by it. Taxes paid or accrued by such a foreign corporation are deemed to have been paid by the domestic corporation for purposes of credit only. For other limitations on the amount of credit, see § 1.904–1.

(2) For purposes of section 902 and this section, the accumulated profits of a foreign corporation consist of its gains, profits, or income in excess of the income, war profits, or excess profits taxes imposed on or with respect to such gains, profits, or income. The district director in whose district is filed the income tax return of the taxpayer claiming a credit by virtue of the provisions of section 902 shall have the power to determine from the accumulated profits of what year or years the dividends received were paid. In making such determination, any dividends which are

paid in the first sixty days of any year shall be treated as having been paid from the accumulated profits of the preceding year or years (unless to the district director's satisfaction shown otherwise), and in other respects such dividends shall be treated as having been paid from the most recently accumulated profits.

(b) *Foreign corporation owning stock of another foreign corporation.* If any foreign corporation (hereafter in this paragraph referred to as the former corporation) coming within the scope of paragraph (a) of this section owns 50 percent or more of the voting stock of another foreign corporation (hereafter in this paragraph referred to as the latter corporation) from which it receives dividends in any taxable year, the former corporation shall be deemed to have paid that proportion of any income, war profits, and excess profits taxes paid or accrued to any foreign country or to any possession of the United States by the latter corporation, on or with respect to the accumulated profits of such latter corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits. Such tax so deemed to have been paid shall then be taken into consideration in determining the amount of income, war profits, and excess profits taxes paid or deemed to have been paid by the former corporation to any possession or foreign country on or with respect to its own accumulated profits from which the dividends were paid by such corporation to the domestic corporation.

(c) *Source of income of foreign subsidiaries and country to which tax is deemed to have been paid.* For the purpose of section 904, dividends of a foreign corporation (at least 10 percent of whose voting stock is owned by a domestic corporation) shall be deemed to have been derived from sources within the foreign country or possession of the United States in which such foreign corporation is incorporated, to the extent that under section 862 (a) (2) such dividends are treated as income from sources without the United States. In addition, all income, war profits, and excess profits taxes paid or deemed to have been paid by such foreign corporation to any foreign country or possession of the United States shall be deemed to have been paid to the country or possession under whose laws such foreign corporation is incorporated.

(d) *Illustration of principles.* The application of the principles of this section in the determination of the amount of the foreign tax available as a basis for a credit to the domestic corporation may be illustrated by the following example involving Corporation A, a domestic corporation which owns 40 percent of the voting stock of Corporation B, a foreign corporation which in turn owns 80 percent of the voting stock of Corporation C, another foreign corporation. It is assumed that all transactions have taken place within, and are related to, the same taxable year.

(1) *Application of section 902 (b) to determine tax deemed to be paid by Corporation B.*

(i) Gains, profits, and income of Corporation C	$125,000
(ii) Foreign tax paid by Corporation C with respect to such gains, profits, and income	25,000
(iii) Accumulated profits of Corporation C: $125,000 less $25,000	100,000
(iv) Dividends paid by Corporation C to Corporation B	50,000
(v) Corporation C foreign tax with respect to the accumulated profits of Corporation C from which the dividends were paid to Corporation B: $\$25,000 \times \frac{100,000}{125,000}$	20,000
(vi) Corporation C foreign tax with respect to the accumulated profits distributed which is deemed to be paid by Corporation B: $\$20,000 \times \frac{50,000}{100,000}$	10,000

(2) *Application of section 902 (a) to determine tax deemed to be paid by Corporation A.*

(i) Gains, profits, and income of Corporation B:		
Business profits	$50,000	
Dividends from Corporation C (as per subparagraph (1) of this paragraph)	50,000	$100,000
(ii) Foreign tax actually paid by Corporation B with respect to such gains, profits, and income		$20,000
(iii) Accumulated profits of Corporation B: $100,000 income less $20,000 taxes paid		80,000
(iv) Dividends paid by Corporation B to Corporation A		15,000
(v) Corporation B foreign tax paid with respect to the accumulated profits of Corporation B from which the dividends were paid to Corporation A: $\$20,000 \times \frac{80,000}{100,000}$		16,000
(vi) Corporation B foreign tax paid, and deemed to be paid, with respect to the accumulated profits of Corporation B from which the dividends were paid to Corporation A: $16,000 plus $10,000		26,000
(vii) Corporation B foreign tax with respect to the accumulated profits distributed which is deemed to be paid by Corporation A: $\frac{15,000}{80,000} \times \$26,000$		4,875

(e) *United Kingdom income taxes paid with respect to royalties.* Under section 902, a taxpayer shall not be deemed to have paid any taxes with respect to which a credit is allowable to such taxpayer or any other taxpayer by virtue of the provisions of section 905(b).

§ 1.902–2 Special rules for payments from certain wholly-owned foreign corporations.

(a) *Qualifications.* Section 902(d) provides a special rule for the purpose of allowing credit in accordance with section 902 (a) for foreign taxes in the case of dividends paid by certain foreign corporations. Certain payments made by a wholly-owned foreign subsidiary to its domestic parent corporation shall be treated, to the extent prescribed in section 902 (d) and paragraph (b) of this section, as distributions by the foreign corporation to the domestic corporation for purposes of subtitle A of the Code and thus for purposes of the foreign tax credit of the domestic parent. In order for the payments to qualify for the treatment provided by section 902 (d) all the following conditions must be met:

(1) The domestic corporation must own (directly or indirectly) 100 percent of all classes of outstanding stock of a foreign corporation which is engaged in manufacturing, production, or mining.

(2) Such domestic corporation must receive property (including money) in the form of a royalty, or of compensation, from such foreign corporation pursuant to any form of contractual arrangement under which the domestic corporation agrees to furnish services or property in consideration for the property so received from the foreign corporation.

(3) Such contractual arrangement must provide that the property so received by such domestic corporation shall be accepted by such domestic corporation in lieu of dividends and that such foreign corporation shall neither declare nor pay any dividends of any kind in any calendar year in which such property is paid to the domestic corporation by such foreign corporation.

(b) *Amount and nature of distribution.* In cases where section 902 (d) applies, the excess of the fair market value of the property so received in lieu of dividends by the domestic corporation over the cost to it of the property and services so furnished by it shall be treated as a distribution of property by the foreign corporation to which section 301 applies. For purposes of section 301 (relating to distributions of property by a corporation to a shareholder) the amount of such distribution in lieu of dividends shall be such excess of the fair market value (on the date of distribution) of the property received by the domestic corporation over the cost of the property and services furnished by it, in lieu of any amount otherwise determined under section 301 without regard to section 902 (d). However, the amount determined under the preceding two sentences can not exceed the amount which would constitute a dividend for the purposes of subtitle A of the Code, and thus for the purposes of section 902(a), if such excess had been declared and paid as a dividend by such foreign corporation. Any adjustment to the earnings and profits of the foreign corporation because of such distribution of property shall be made only in accordance with the provisions of section 312. The basis

of the property so received by the domestic corporation shall be the fair market value of such property (on the date of distribution), in lieu of the basis otherwise determined under section 301 (d) without regard to section 902 (d).

(c) *Illustration of principles.* The application of the principles of section 902 (d) may be illustrated by the following example:

Example. A, a domestic corporation, has owned since January 1, 1950, 100 percent of all classes of outstanding stock of B, a foreign corporation engaged in the mining of certain ore (not constituting inventory assets as defined in section 312 (b) (2) (A)). On February 1, 1950, A and B entered into a contractual arrangement under which A agreed to furnish technical services to B in consideration of a royalty payment by B of ten percent of the ore mined. The contractual arrangement further provides that the ore received by A shall be accepted in lieu of dividends and that B shall neither declare nor pay any dividends of any kind in any calendar year in which such ore is paid to A. In 1955, the cost to A of the technical services furnished under the contractual arrangement is $30,000. The ore received by A during 1955, had an adjusted basis in the hands of B of $40,000, and a fair market value of $100,000. The earnings and profits of B accumulated as of the close of 1955, are $200,000. Under these facts A has received from B in 1955 a distribution under section 902 (d) of $70,000 ($100,000 minus $30,000), which is includible in the gross income of A as a dividend in that amount. A is deemed to have paid, to the extent provided in section 902 (a), foreign income taxes imposed on B on or with respect to the accumulated profits of B from which such dividend of $70,000 was paid. The basis to A of the ore received is $100,000, its fair market value. The accumulated earnings and profits of B shall be reduced by $28,000 $\left(\frac{\$70,000}{\$100,000} \times \$40,000\right)$, i. e., that portion of the adjusted basis (in the hands of B immediately prior to the distribution) of the property distributed which is allocable to the distribution.

§ 1.903 Statutory provisions; credit for taxes in lieu of income, etc., taxes.

SEC. 903. *Credit for taxes in lieu of income, etc., taxes.* For purposes of this subpart and of section 164 (b), the term "income, war profits, and excess profits taxes" shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

§ 1.903–1 Definition of taxes in lieu of income, war profits, or excess profits taxes.

(a) *In general.* For the purposes of subpart A (section 901 and following), part III, subchapter N, chapter 1 of the Code, and section 164(b)(6), the term "income, war profits, and excess profits taxes" includes a tax imposed by statute or decree by a foreign country or by a possession of the United States if—

(1) Such country or possession has in force a general income tax law,

(2) The taxpayer claiming the credit would, in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax, and

(3) Such general income tax is not imposed upon the taxpayer thus subject to such substituted tax.

(b) *Example.* The application of section 903 may be illustrated by the following example:

Example. The A Corporation does business in X country, which imposes an income tax upon substantially a taxable income base. The ascertainment of taxable income, though not the determination of gross income, from sources in X country is found administratively difficult. The X country, by decree, provides that corporations circumstanced as was the A Corporation would, in lieu of the income tax at the rate of 20 percent otherwise payable, be subject to tax at the rate of 10 percent upon the amount of gross income from X country. In accordance with such decree the A Corporation paid X country the sum of $25,000 in 1955 with respect to its tax liability to the X country for the year 1954. Such amount, subject to the applicable limitations, is available as a credit to the A Corporation as foreign income, war profits, or excess profits taxes against the United States tax liability for the year 1954.

§ 1.904 Statutory provisions; limitation on credit.

SEC. 904. *Limitation on credit*—(a) *Limitation.* The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources within such country (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

(b) *Taxable income for purpose of computing limitation.* For purposes of computing the limitation under subsection (a), the taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642 (b).

§ 1.904–1 Limitation on credit for foreign taxes.

(a) *General.* The amount allowable as a credit for income or profits taxes paid or accrued to a foreign country or a possession of the United States is subject to the limitation prescribed in section 904. This limitation provides that the credit for such taxes paid or accrued (including those deemed to have been paid) to each foreign country or possession of the United States may not exceed that proportion of the tax against which credit is taken which the taxpayer's taxable income from sources within such country or possession (but not in excess of taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

(b) *Special computation of taxable income.* For purposes of computing the limitation under paragraph (a), the taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642 (b).

(c) *Illustration of principles.* The operation of this limitation on the credit for foreign taxes paid or accrued may be illustrated by the following examples:

Example (1). The credit for foreign taxes allowable for 1954 in the case of X, an unmarried citizen of the United States who in 1954 received the income shown below and had three exemptions under section 151, is $14,904, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States	$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain	25,000
Total taxable income	75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions)	44,712
British income and profits taxes	18,000
Limitation under section 904 $\left(\frac{25,000}{75,000} \text{ of } \$44,712\right)$	14,904
Credit for British income and profits taxes (total British income and profits taxes, reduced in accordance with the limitation under section 904)	$14,904

Example (2). Assume the same facts as in example (1), except that the sources of X's income and taxes paid are as shown below. The credit for foreign taxes allowable to X is $13,442.40, computed as follows:

Taxable income (computed without deductions for personal exemptions) from sources within the United States	$50,000
Taxable income (computed without deductions for personal exemptions) from sources within Great Britain	15,000
Taxable income (computed without deductions for personal exemptions) from sources within Canada	10,000
Total taxable income	75,000
United States income tax (based on taxable income computed with the deductions for personal exemptions)	44,712
British income and profits taxes	10,800
Limitation on British income and profits taxes under section 904 $\left(\frac{15,000}{75,000} \text{ of } \$44,712\right)$	8,942.40
Credit for British income and profits taxes (limited under section 904)	8,942.40
Canadian income and profits taxes	4,500.00
Limitation on Canadian income and profits taxes under section 904 $\left(\frac{10,000}{75,000} \text{ of } \$44,712\right)$	5,961.60
Credit for Canadian income and profits taxes (total Canadian income and profits taxes, since such amount does not exceed the limitation under section 904)	4,500.00
Total amount of credit allowable (sum of credits—$8,942.40 plus $4,500)	13,442.40

Example (3). A domestic corporation realized taxable income in 1954 in the amount of $100,000, consisting of $50,000 from United States sources and dividends of $50,000 from a French corporation, 20 percent of whose voting stock it owned. The French corporation paid income and profits taxes to France on its income and in addition paid a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source. The domestic corporation's credit for foreign taxes is $23,250, computed as follows:

Taxable income from sources within the United States	$50,000
Taxable income from sources within France	50,000
Total taxable income	100,000
United States income tax	46,500
Dividend tax paid at source to France	19,000
Income and profits taxes deemed under section 902 to have been paid to France, computed as follows:	
Dividends received from French corporation during 1954	$50,000
Income of French corporation during 1954	200,000
Income and profits taxes paid to France on $200,000	30,000
Accumulated profits ($200,000 minus $30,000)	170,000
French taxes applicable to accumulated profits distributed: $\frac{50,000}{170,000}$ of $\frac{170,000}{200,000}$ of $30,000	7,500
Total income and profits taxes paid and deemed to have been paid to France	26,500
Limitation under section 904 $\left(\frac{50,000}{100,000}\right.$ of $46,500$	23,250
Credit for French income and profits taxes (limited under section 904)	23,250

(d) *Joint return.* In the case of a husband and wife making a joint return, the limitation prescribed by section 904 upon the credit for taxes paid or accrued to any foreign country or to any possession of the United States shall be applied with respect to the aggregate taxable income from sources within each such country or possession, and the aggregate taxable income from all sources, of the spouses.

§ 1.905 Statutory provisions; applicable rules.

SEC. 905. *Applicable rules*—(a) *Year in which credit taken.* The credits provided in this subpart may, at the option of the taxpayer and irrespective of the method of accounting employed in keeping his books, be taken in the year in which the taxes of the foreign country or the possession of the United States accrued, subject, however, to the conditions prescribed in subsection (c). If the taxpayer elects to take such credits in the year in which the taxes of the foreign country or the possession of the United States accrued, the credits for all subsequent years shall be taken on the same basis, and no portion of any such taxes shall be allowed as a deduction in the same or any succeeding year.

(b) *Proof of credits.* The credits provided in this subpart shall be allowed only if the taxpayer establishes to the satisfaction of the Secretary or his delegate—

(1) The total amount of income derived from sources without the United States, determined as provided in part I,

(2) The amount of income derived from each country, the tax paid or accrued to which is claimed as a credit under this subpart, such amount to be determined under regulations prescribed by the Secretary or his delegate, and

(3) All other information necessary for the verification and computation of such credits.

For purposes of this subpart, the recipient of a royalty or other amount paid or accrued as consideration for the use of, or for the privilege of using, copyrights, patents, designs, secret processes and formulas, trademarks, and other like property, and derived from sources within the United Kingdom of Great Britain and Northern Ireland, shall be deemed to have paid or accrued any income, war-profits and excess-profits taxes paid or accrued to the United Kingdom with respect to such royalty or other amount (including the amount by which the payor's United Kingdom tax was increased by inability to deduct such royalty or other amount) if such recipient elects to include in its gross income the amount of such United Kingdom tax.

(c) *Adjustments on payment of accrued taxes.* If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary or his delegate, who shall redetermine the amount of the tax for the year or years affected. The amount of tax due on such redetermination, if any, shall be paid by the taxpayer on notice and demand by the Secretary or his delegate, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with subchapter B of chapter 66 (sec. 6511 and following). In the case of such a tax accrued but not paid, the Secretary or his delegate, as a condition precedent to the allowance of this credit may require the taxpayer to give a bond, with sureties satisfactory to and to be approved by the Secretary or his delegate, in such sum as the Secretary or his delegate may require, conditioned on the payment by the taxpayer of any amount of tax found due on any such redetermination; and the bond herein prescribed shall contain such further conditions as the Secretary or his delegate may require. In such redetermination by the Secretary or his delegate of the amount of tax due from the taxpayer for the year or years affected by a refund, the amount of the taxes refunded for which credit has been allowed under this section shall be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund; but no credit under this subpart, and no deduction under section 164 (relating to deduction for taxes) shall be allowed for any taxable year with respect to such tax imposed on the refund. No interest shall be assessed or collected on any amount of tax due on any redetermination by the Secretary or his delegate, resulting from a refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

[Sec. 905 as amended by sec. 103(b), Technical Amendments Act 1958 (72 Stat. 1675)]

§ 1.905–1 When credit for taxes may be taken.

(a) *In general.* The credit for taxes provided in subpart A (section 901 and following), part III, subchapter N, chapter 1 of the Code, may ordinarily be taken either in the return for the year in which the taxes accrued or in which the taxes were paid, dependent upon whether the accounts of the taxpayer are kept and his returns filed using an accrual method or using the cash receipts and disbursements method. Section 905(a) allows the taxpayer, at his option and irrespective of the method of accounting employed in keeping his books, to take such credit for taxes as may be allowable in the return for the year in which the taxes accrued. An election thus made under section 905(a) (or under the corresponding provisions of prior internal revenue laws) must be followed in returns for all subsequent years, and no portion of any such taxes accrued in a year in which a credit is claimed will be allowed as a deduction from gross income in any year. See also § 1.905–4.

(b) *Foreign income subject to exchange controls.* If, however, under the provisions of the regulations under section 461, an amount otherwise constituting gross income for the taxable year from sources without the United States is, owing to monetary, exchange, or other restrictions imposed by a foreign country, not includible in gross income of the taxpayer for such year, the credit for income taxes imposed by such foreign country with respect to such amount shall be taken proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income.

§ 1.905–2 Conditions of allowance of credit.

(a) *Forms and information.* (1) Whenever the taxpayer chooses, in accordance with paragraph (d) of § 1.901–1, to claim the benefits of the foreign tax credit, the claim for credit shall be accompanied by Form 1116 in the case of an individual or by Form 1118 in the case of a corporation.

(2) The form must be carefully filled in with all the information called for and with the calculations of credits indicated, and must be signed and contain or be verified by a written declaration that it is made under the penalties of perjury. Except where it is established to the satisfaction of the district director that it is impossible for the taxpayer to furnish such evidence, the form must have attached to it (i) the receipt for each such tax payment if credit is sought for taxes already paid or (ii) the return on which each such accrued tax was based if credit is sought for taxes accrued. This receipt or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original, or a duly certified or authenticated copy. If the receipt or the return is in a foreign language, a certified translation thereof must be furnished by the taxpayer. Any additional information necessary for the determination under part I (section 861 and following), subchapter N, chapter 1 of the Code, of the amount of income derived from sources without the United States and from each foreign country shall, upon the request of the district director, be furnished by the taxpayer.

(b) *Secondary evidence.* Where it has been established to the satisfaction of the district director that it is impossible to furnish a receipt for such foreign tax payment, the foreign tax return, or direct evidence of the amount of tax

withheld at the source, the district director, may, in his discretion, accept secondary evidence thereof as follows:

(1) *Receipt for payment.* In the absence of a receipt for payment of foreign taxes there shall be submitted a photostatic copy of the check, draft, or other medium of payment showing the amount and date thereof, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his own tax on his own income. If credit is claimed on an accrual method, it must be shown that the tax accrued in the taxable year.

(2) *Foreign tax return.* If the foreign tax return is not available, the foreign tax has not been paid, and credit is claimed on an accrual method, there shall be submitted—

(i) A certified statement of the amount claimed to have accrued,

(ii) Excerpts from the taxpayer's accounts showing amounts of foreign income and tax thereon accrued on its books.

(iii) A computation of the foreign tax based on income from the foreign country carried on the books and at current rates of tax to be established by data such as excerpts from the foreign law, assessment notices, or other documentary evidence thereof,

(iv) A bond, if deemed necessary by the district director, filed in the manner provided in cases where the foreign return is available, and

(v) In case a bond is not required, a specific agreement wherein the taxpayer shall recognize its liability to report the correct amount of tax when ascertained, as required by the provisions of section 905 (c).

If at any time the foreign tax receipts or foreign tax returns become available to the taxpayer, they shall be promptly submitted to the district director.

(3) *Tax withheld at source.* In the case of taxes withheld at the source from dividends, interest, royalties, compensation, or other form of income, where evidence of withholding and of the amount withheld cannot be secured from those who have made the payments, the district director may, in his discretion, accept secondary evidence of such withholding and of the amount of the tax so withheld, having due regard to the taxpayer's books of account and to the rates of taxation prevailing in the particular foreign country during the period involved.

§ 1.905–3 Redetermination of the tax when credit proves incorrect.

(a) *In general.* In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the district director. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited or refunded to the taxpayer in accordance with the provisions of § 301.6511(d)–3 of this chapter (Regulations on Procedure and Administration).

(b) *Foreign tax imposed on foreign refund.* Where the redetermination of the tax for a taxable year, or years, is occasioned by the refund to the taxpayer of tax paid to a foreign country or possession of the United States, the amount of the taxes refunded for which credit has been allowed shall be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund. In such case no credit under section 901, and no deduction under section 164, shall be allowed for any taxable year with respect to such tax imposed on the refund.

(c) *Interest.* Where the redetermination of the tax for a taxable year, or years, is occasioned by the refund to the taxpayer of tax paid to a foreign country or possession of the United States, no interest shall be assessed or collected on the amount of tax due upon such redetermination resulting from such refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period.

§ 1.905–4 Credit for taxes accrued but not paid.

In the case of a credit sought for a tax accrued but not paid, the district director may, as a condition precedent to the allowance of a credit, require a bond from the taxpayer, in addition to Form 1116 or 1118. If such a bond is required, Form 1117 shall be used by an individual or by a corporation. It shall be in such sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the district director may require. This bond shall be executed by the taxpayer, or the agent or representative of the taxpayer, as principal, and by sureties satisfactory to and approved by the Commissioner. See also 6 U. S. C. 15.

§ 1.905–5 Credit for United Kingdom income taxes paid with respect to royalties.

(a) *General rule.* (1) The taxes deemed to have been paid or accrued under subparagraph (2) of this paragraph by a taxpayer are taxes for which a credit is allowable under section 901.

(2) A taxpayer who has received a royalty (as defined in paragraph (b) of this section) derived from sources within the United Kingdom of Great Britain and Northern Ireland is deemed to have paid or accrued any income, war-profits, or excess-profits taxes paid or accrued to the United Kingdom with respect to such royalty (including the amount by which the payor's United Kingdom tax was increased by inability to deduct such royalty), but only if the taxpayer elects to include in his gross income the amount of such United Kingdom tax. The election provided for in section 905 (b) and this subparagraph shall apply only to amounts that are not otherwise includible in gross income under chapter 1.

(3) The credit under this section for taxes deemed paid or accrued with respect to a royalty is allowable in the taxable year in which, under the method of accounting used by the taxpayer, the royalty is includible in his gross income.

(4) No interest shall be allowed or paid on any overpayment resulting from the application of the last sentence of section 905(b) and this section.

(b) *Definition of "royalty".* For purposes of this section, the term "royalty" means a royalty or other amount paid or accrued as consideration for the use of, or for the privilege of using, copyrights, patents, designs, secret processes and formulas, trademarks, and other like property.

(c) *Illustrations.* This section may be illustrated by the following examples:

Example (1). A, a resident of the United Kingdom, has agreed to pay B, a resident of the United States, a royalty of $1,000 per year for the use in the United Kingdom of a patent. At all pertinent times, B is engaged in a trade or business in the United Kingdom through a permanent establishment therein. B computes his taxable income under the cash receipts and disbursements method and files his Federal income tax returns on the calendar year basis. Assume that the United Kingdom standard tax rate is 42.5 percent and assume further that in 1957 A pays the yearly royalty to B and that such royalty is payable wholly out of profits or gains brought into charge to tax within the meaning of the United Kingdom law. Under such circumstances, A is not entitled to a deduction for the royalty in computing his United Kingdom income taxes but may withhold the amount of $425 from the royalty as reimbursement for being denied a deduction. Although B will receive only $575 in 1957, he may include in his gross income for that year the full $1,000 on account of the royalty, instead of just the $575 received and, subject to the limitations contained in section 904, may obtain a credit for the $425 withheld by A. Furthermore, the result would be the same if, under United Kingdom law, the $425 was withheld as tax payable to the United Kingdom by reason that the royalty was not payable out of profits or gains brought into charge to tax.

Example (2). Assume the same facts as stated in example (1), except that the $575 is received by B in 1957 under a "net royalty" agreement. Under such circumstances, B may include in his gross income $1,000 on account of the royalty and, subject to the limitations contained in section 904, may obtain a credit for $425.

EARNED INCOME OF CITIZENS OF UNITED STATES

§ 1.911 Statutory provisions; earned income from sources without the United States.

SEC. 911. *Earned income from sources without the United States*—(a) *General rule.* The following items shall not be included in

gross income and shall be exempt from taxation under this subtitle:

(1) *Bona fide resident of foreign country.* In the case of an individual citizen of the United States, who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) *Presence in foreign country for 17 months.* In the case of an individual citizen of the United States, who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or an agency thereof) if such amounts constitute earned income (as defined in subsection (b)) attributable to such period; but such individual shall not be allowed as a deduction from his gross income any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph. If the 18-month period includes the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed $20,000. If the 18-month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year.

(b) *Definition of earned income.* For purposes of this section, the term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.

(c) *Cross reference.* For administrative and penal provisions relating to the exclusion provided for in this section, see sections 6001, 6011, 6012(c), and the other provisions of subtitle F.

[Sec. 911 as amended by sec. 72(b), Technical Amendments Act 1958 (72 Stat. 1660)]

§ 1.911–1 Earned income from sources without the United States.

(a) *Bona fide resident of a foreign country*—(1) *Qualifications for exemption.* Amounts constituting earned income as defined in section 911(b) shall be excluded from the gross income of an individual citizen of the United States who establishes to the satisfaction of the Commissioner that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, if such amounts are (i) from sources without the United States, (ii) attributable to such uninterrupted period, and (iii) not paid by the United States or any agency or instrumentality thereof. The exemption from tax thus provided is applicable to such amounts as are attributable to that portion of an uninterrupted period of bona fide foreign residence which falls within a taxable year during which the citizen begins or terminates bona fide residence in a foreign country, provided that such period includes at least one entire taxable year. If attributable to an uninterrupted period in respect of which the citizen qualifies for the exemption from tax thus provided, the amounts shall be excluded from gross income irrespective of when they are received.

(2) *What constitutes bona fide residence.* Though the period of bona fide foreign residence must be continuous and uninterrupted, once bona fide residence in a foreign country or countries has been established, temporary visits to the United States or elsewhere on vacation or business trips will not necessarily deprive the citizen of his status as a bona fide resident of a foreign country. Whether the individual citizen of the United States is a bona fide resident of a foreign country shall be determined by the application, to the extent feasible, of the principles of section 871 and the regulations thereunder, relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of an alien individual.

(3) *Treatment of deductions.* In any case in which any amount is excluded from gross income under the provisions of section 911 (a) (1), there shall be disallowed as deductions any expenses, losses, or other items otherwise deductible (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against the amounts so excluded from gross income. For example, traveling and entertainment expenses incurred by A, a citizen of the United States, for the production of earned income in foreign country X, where A had been a bona fide resident for a period of several years, would not be deductible to any extent, since such expenses are directly and entirely allocable to or chargeable against such exempt earned income. However, items which are not properly chargeable against or allocable to excludable earned income are deductible in their entirety (subject to any specific statutory limitations relating to such items). Examples of such items include personal and family medical expenses, real estate taxes on a personal residence, interest on mortgage on personal residence, and charitable contributions.

(4) *Earned income and employed assistants.* The entire amount received as professional fees shall be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor or a lawyer, even though he employs assistants to perform part or all of the services, provided the patients or clients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed.

(5) *Earned income from business in which capital is material.* In the case of a taxpayer engaged in a trade or business (other than in corporate form) in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer shall be considered earned income, but the total amount which shall be treated as the earned income of the taxpayer from such a trade or business shall, in no case, exceed 30 percent of his share of the net profits of such trade or business. No general rule can be prescribed defining the trades or businesses in which personal services and capital are material income-producing factors; this question must be determined on all the facts of each individual case.

(6) *Source of income and place of receipt.* An amount constituting earned income as defined in section 911 (b) which is derived from sources without the United States shall not be included in gross income solely because it is received within the United States, since the place of receipt is immaterial in determining whether any items shall be excluded from gross income under the provisions of section 911 (a). No amounts received for services performed within the United States shall be excluded from gross income by such section. For the allocation or segregation as between sources within, and sources without, the United States in the case of compensation for labor or personal services, see part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(7) *Returns.* Any return filed before the completion of the period necessary to qualify a citizen for the exemption under section 911(a)(1) shall be filed without regard to the exemption provided by that section, but claim for credit or refund of any overpayment of tax may be filed if the taxpayer subsequently qualifies for the exemption under section 911(a)(1). A taxpayer desiring an extension of time (in addition to the automatic extension of time granted by § 1.6081–2) for filing the return until after the completion of the qualifying period under section 911(a)(1) shall make application therefor on Form 2350, Application for Extension of Time for Filing U.S. Income Tax Return. Such application shall be filed with the internal revenue officer (Director of International Operations, Internal Revenue Service, Washington 25, D.C., or the district director) with whom the return is required to be filed. The application shall set forth the facts relied upon to

justify the extension of time requested and include a statement as to the earliest date the taxpayer expects to be in a position to determine whether he will be entitled to the exclusion provided by section 911(a)(1). An extension of time may be granted for more than 6 months in the case of taxpayers who are abroad. See section 6081 and § 1.6081–1. See section 6012(c) and paragraph (a)(3) of § 1.6012–1 relating to the returns to be filed and the information to be furnished by individuals who qualify for exemption under section 911.

(8) *Declaration of estimated tax.* In estimating his gross income for the purpose of making a declaration of estimated tax for any taxable year, a citizen of the United States is not required to take into account income which it is reasonable to believe will be excluded from gross income under the provisions of section 911 (a) (1) and the regulations thereunder.

(9) *Definition of "foreign country".* The term "foreign country" means territory under the sovereignty of a government other than that of the United States. It does not include a possession or Territory of the United States.

(b) *Presence in a foreign country—* (1) *Qualifications for exemption.* Subject to the limitations in subparagraph (2) of this paragraph, amounts constituting earned income as defined in section 911 (b) shall be excluded from gross income in the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during a total of at least 510 full days, if such amounts are (i) from sources without the United States, (ii) attributable to such period, and (iii) not paid by the United States or any agency or instrumentality thereof. For purposes of determining the right to the exclusion under section 911 (a) (2) for a taxable year to which the Internal Revenue Code of 1954 is applicable, the period of presence in a foreign country may include a period prior to the beginning of such taxable year, even though the tax for such prior period is computed under the Internal Revenue Code of 1939. For example, the qualifying period may, in the case of a taxpayer who makes his return on the calendar year basis, cover the period from July 1, 1953, to December 31, 1954, for purposes of the exclusion allowed under section 911 (a) (2) for the taxable year 1954.

(2) *Amount of exemption.* (i) The amount excluded from gross income under the provisions of section 911 (a) (2) shall not exceed $20,000 if the 18-month period includes the entire taxable year. If the 18-month period does not include the entire taxable year, the amount excluded from gross income under such section for such taxable year shall not exceed an amount which bears the same ratio to $20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. A, a citizen of the United States who files his returns for the calendar year using a cash receipts and disbursements method, was privately employed and physically present in France from January 1, 1953, through July 15, 1955. On December 31, 1953, he received compensation in the amount of $20,000 for the services rendered by him during 1953. He left France on July 16, 1955, and returned to the United States. On August 1, 1955, he received $30,000, part of which was for the services rendered by him during 1954 and the balance of which was for his services rendered during the period January 1, 1955, through July 15, 1955. On January 15, 1956, A received an additional $10,000 for the services rendered by him during 1954.

(*a*) Since the $20,000 compensation received by A on December 31, 1953, was attributable to an 18-month period during at least 510 full days of which he was present in a foreign country, and since that 18-month period included his entire taxable year 1953, the entire $20,000 is exempt from taxation.

(*b*) Only $12,712.33 ($\frac{232}{365} \times \$20,000$) of the $30,000 received by A on August 1, 1955, is exempt from taxation since only 232 days of his taxable year 1955 is included within such an 18-month period. The number of days (232) is determined by treating the first day of the 18-month period as coinciding with the first day of the 510-day period. The first day of the 510-day period ending July 15, 1955 (the last full day A was present in France), was February 21, 1954. Commencing with February 21, 1954, the 18-month period ends August 20, 1955. The number of days in that part of 1955 falling within the 18-month period is, therefore, 232 (January 1, 1955, through August 20, 1955). The amount excludable by A in 1955 ($12,712.33) is computed on the basis of the following formula:

$$\frac{\text{Number of days in that part of the taxable year falling within the 18-month period}}{\text{Number of days in the taxable year}} \times \$20{,}000 \text{ (Maximum amount excludable for an entire taxable year under section 911 (a) (2))},$$

or $\frac{232}{365} \times \$20{,}000$.

(*c*) None of the $10,000 attributable to the services rendered by A during 1954 but received by him in 1956 is exempt from taxation because no part of his taxable year 1956 is included within an 18-month period. For the definition of "taxable year," see section 7701 (a) (23).

(3) *Returns.* Any return filed before the completion of the period necessary to qualify a citizen for the exemption under section 911(a)(2) shall be filed without regard to the exemption provided by that section, but claim for credit or refund of any overpayment of tax may be filed if the taxpayer subsequently qualifies for the exemption under section 911(a)(2). A taxpayer desiring an extension of time (in addition to the automatic extension of time granted by § 1.6081–2) for filing the return until after the completion of the qualifying period under section 911(a)(2) shall make application therefor on Form 2350, Application for Extension of Time for Filing U.S. Income Tax Return. Such application shall be filed with the internal revenue officer (Director of International Operations, Internal Revenue Service, Washington 25, D.C., or the district director) with whom the return is required to be filed. The application shall set forth the facts relied upon to justify the extension of time requested and include a statement as to the earliest date the taxpayer expects to be in a position to determine whether he will be entitled to the exclusion provided by section 911(a)(2). An extension of time may be granted for more than 6 months in the case of taxpayers who are abroad. See section 6081 and § 1.6081–1. See section 6012(c) and paragraph (a)(3) of § 1.6012–1 relating to the returns to be filed and the information to be furnished by individuals who qualify for exemption under section 911.

(4) *Declaration of estimated tax.* In estimating his gross income for the purpose of making a declaration of estimated tax for any taxable year, a citizen of the United States is not required to take into account income which it is reasonable to believe will be excluded from gross income under the provisions of section 911 (a) (2) and the regulations thereunder.

(5) *Earned income, source of income, and place of receipt.* The provisions of paragraph (a) of this section respecting the definition of earned income, the source of income, and the immateriality of the place of receipt of amounts constituting earned income are equally effective in the application of this paragraph.

(6) *Treatment of deductions.* In any case in which any amount is excluded from gross income under section 911 (a) (2), there shall be disallowed as deductions any expenses, losses, or other items otherwise deductible (other than those allowed by section 151 relating to personal exemptions), properly allocable to or chargeable against the amount so excluded from gross income. If the earned income excludable under section 911 (a) (2) (determined without regard to the $20,000 limitation) exceeds the earned income excludable under section 911 (a) (2), the amount disallowed as a deduction shall be limited to an amount which bears the same ratio to the total of such items properly allocable to or chargeable against such earned income so excludable (determined without regard to the $20,000 limitation) as the amount excluded from gross income under section 911 (a) (2) bears to such earned income (determined without regard to the $20,000 limitation). However, deductions which are not properly allocable to or chargeable against earned income excluded under section 911 (a) (2) are deductible in their entirety (subject to specific statutory limitations relating to such items). For examples of deductions which must be allowed or disallowed under this paragraph, see paragraph (a) (3) of this section.

(7) *Definition of "foreign country."* The term "foreign country" means territory under the sovereignty of a government other than that of the United

States and includes the air space over such territory. It does not include a possession or Territory of the United States.

(8) *Determination of 18-month period.* The exclusion provided by section 911 (a) (2) applies to income attributable to any period of 18 consecutive months during which the citizen satisfies the 510 full-day requirement, even though such period constitutes a part of a longer period of presence in a foreign country or countries. For this purpose, the term "18 consecutive months" means any period of such duration, that is, any period commencing with the beginning of any day of a calendar month and terminating (i) with the close of the day which precedes that day in the eighteenth succeeding calendar month numerically corresponding to the day of the period's beginning, or, if there is no such corresponding day, (ii) with the close of the last day of such eighteenth succeeding month. Such period need not necessarily commence with the day of arrival in a foreign country, nor terminate with the day of departure therefrom. In no event will the 510 full-day requirement be prorated over a period of less than 18 consecutive months.

(9) *Examples of 18-month periods.* A citizen who arrives in a foreign country on January 1, 1953, makes several return trips to the United States, and then finally departs from the foreign country on February 14, 1955, may not be present in such country for 510 full days during the 18-month period commencing with January 1, 1953, and ending with the close of June 30, 1954, because of his visits to the United States during such period, but may satisfy the 510 full-day requirement during the 18-month period commencing with February 15, 1953, and ending with the close of August 14, 1954. In such event, the exclusion will apply to income attributable to the latter period, but not to income attributable to the period commencing with January 1, 1953, and ending with the close of February 14, 1953. For such purpose, it is assumed that no part of the period ending with the close of February 14, 1953, is included in any 18-month period during which the 510 full-day requirement is satisfied. Furthermore, the mere fact that the 510 full-day requirement has been satisfied with respect to the period ending with the close of August 14, 1954, does not mean that income earned thereafter will be excluded under section 911 (a) (2) unless such income is attributable to another 18-month period during which there is compliance with the 510 full-day requirement. Thus, the 510 full-day requirement cannot be prorated over the 6-month period commencing with August 15, 1954, and ending with the close of February 14, 1955, in order to determine whether the exclusion allowed by section 911 (a) (2) applies to income attributable to such 6-month period. Therefore, assuming that the citizen is present in the foreign country 170 full days (⅓ of 510 full days) during such 6-month period (⅓ of 18 consecutive months), the exclusion will not be applicable to income attributable to any part of such 6-month period if no part thereof is included in any 18-month period during which the 510 full-day requirement is satisfied.

(10) *Definition of "full day."* The term "full day" means, not any 24-consecutive-hour period, but a continuous period of twenty-four hours commencing from midnight and ending with the following midnight. In computing the minimum of 510 full days of presence in a foreign country or countries, all separate periods of such presence during the period of 18 consecutive months are to be aggregated. For the purpose of section 911 (a) (2), if an individual travels over a route (a portion of which is not within any country) from one place in a foreign country to another place in the same country, or to a place in another foreign country, and if such travel not within any country extends over a period of less than 24 hours and does not involve travel within the United States or any possession thereof, such individual shall not be deemed outside a foreign country during the period of such travel. The 510 full days need not be consecutive, but may be interrupted by periods during which the citizen is not present in a foreign country. Time spent in a foreign country in the employment of the United States Government will count toward satisfaction of the 510 full-day requirement, even though amounts paid by such Government are not exempt from tax under section 911 (a) (2).

(11) *Illustrations of application of the 510-day rule.* The application of the 510-day rule may be illustrated by the following examples:

Example (1). On February 1, 1954, B, a citizen of the United States privately employed, arrived in Puerto Rico on a business assignment. Upon completion of the assignment he departed for a new assignment in Venezuela, arriving there on April 24, 1954. He remained in Venezuela until 2 p. m. on October 25, 1955, at which time he departed for another assignment in Puerto Rico. On January 10, 1956, he left Puerto Rico for a new assignment in the United States. During the 18-month period commencing with April 25, 1954, and ending with the close of October 24, 1955, the taxpayer was in a foreign country at least 510 full days; in addition, during the 18-month period commencing with June 2, 1954, and ending with the close of December 1, 1955, he was in a foreign country an aggregate of 510 full days.

Example (2). At 2 p. m. on January 18, 1953, C, a citizen of the United States privately employed, arrived in England on a business trip from the United States. On May 20, 1953, at 10 p. m. he departed from England by steamer and arrived in the United States on May 25, 1953. After spending a period therein on official business, he left the United States by steamer on June 9, 1953, and arrived in France at 3 p. m., June 14, 1953. At 8 a. m. on February 3, 1954, he departed from France by airplane for a brief visit to Puerto Rico, arriving there on February 4, 1954, and thence went to England, arriving there at 1 a. m. on February 12, 1954, where he remained until midnight, July 18, 1954, at which time the 510 full-day requirement was satisfied in respect of the period of 18 consecutive months which began with January 19, 1953. C continued his presence in England, not leaving that country until 5 a. m. on November 18, 1954, at which time he departed for the United States. During the 18-month period commencing with January 19, 1953, and ending with the close of July 18, 1954, the taxpayer was in a foreign country or countries an aggregate of 510 full days; in addition, during the 18-month period commencing with June 16, 1953, and ending with the close of December 15, 1954, he was in a foreign country or countries an aggregate of 510 full days. The computation with respect to each period may be illustrated as follows:

	Full days in foreign country
First 18-month period (Jan. 19, 1953, through July 18, 1954):	
Jan. 19, 1953, through May 19, 1953	121
May 20, 1953, through June 14, 1953	0
June 15, 1953, through Feb. 2, 1954	233
Feb. 3, 1954, through Feb. 12, 1954	0
Feb. 13, 1954, through July 18, 1954	156
Total full days	510
Second 18-month period (June 16, 1953, through Dec. 15, 1954):	
June 16, 1953, through Feb. 2, 1954	232
Feb. 3, 1954, through Feb. 12, 1954	0
Feb. 13, 1954, through Nov. 17, 1954	278
Nov. 18, 1954, through Dec. 15, 1954	0
Total full days	510

Example (3). On March 6, 1953, at 8 p. m., D, a citizen privately employed, arrived in Cuba, where he remained until 9 p. m., June 25, 1953, at which time he departed from Cuba for a short business trip to Puerto Rico. Upon completion of his negotiations, he departed for Mexico, arriving there at 2 p. m. on July 24, 1953, where he remained until 10 a. m., August 22, 1954, at which time he departed from such country for a vacation in the United States. He arrived again in Mexico at 9 a. m. on September 5, 1954, where he remained until 8 a. m., January 1, 1955, at which time he departed from such country for a new assignment in the United States. During the 18-month period commencing with March 7, 1953, and ending with the close of September 6, 1954, the taxpayer was in a foreign country or countries an aggregate of 504 full days; during the 18-month period commencing with July 1, 1953, and ending with the close of December 31, 1954, he was in a foreign country an aggregate of 510 full days. The computation with respect to each period may be illustrated as follows:

	Full days in foreign country
First 18-month period (Mar. 7, 1953, through Sept. 6, 1954):	
Mar. 7, 1953, through June 24, 1953	110
June 25, 1953, through July 24, 1953	0
July 25, 1953, through Aug. 21, 1954	393
Aug. 22, 1954, through Sept. 5, 1954	0
Sept. 6, 1954	1
Total full days	504
Second 18-month period (July 1, 1953, through Dec. 31, 1954):	
July 1, 1953, through July 24, 1953	0
July 25, 1953, through Aug. 21, 1954	393
Aug. 22, 1954, through Sept. 5, 1954	0
Sept. 6, 1954, through Dec. 31, 1954	117
Total full days	510

§ 1.912 Statutory provisions; exemption for certain allowances.

SEC. 912. *Exemption for certain allowances.* The following items shall not be included in gross income, and shall be exempt from taxation under this subtitle:

(1) *Cost-of-living allowances.* In the case of civilian officers or employees of the Government of the United States stationed outside continental United States, amounts received as cost-of-living allowances in accordance with regulations approved by the President.

(2) *Foreign service allowances.* In the case of an officer or employee of the Foreign Service of the United States, amounts received by such officer or employee as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946 (22 U. S. C. 1131–1158).

§ 1.912–1 Exclusion of certain cost-of-living allowances.

(a) Amounts received by Government civilian personnel stationed outside the continental United States as cost-of-living allowances in accordance with regulations approved by the President are, by the provisions of section 912(1), excluded from gross income. Such allowances shall be considered as retaining their characteristics under section 912(1) notwithstanding any combination thereof with any other allowance. For example, the cost-of-living portion of a "living and quarters allowance" would be excluded from gross income whether or not any other portion of such allowance is excluded from gross income.

(b) For purposes of section 912(1), the term "continental United States" includes only the 48 States existing on February 25, 1944 (the date of the enactment of the Revenue Act of 1943 (58 Stat. 21)) and the District of Columbia.

§ 1.912–2 Exclusion of certain allowances of Foreign Service personnel.

Amounts received by personnel of the Foreign Service of the United States as allowances or otherwise under the terms of title IX of the Foreign Service Act of 1946 (22 U. S. C. 1131–1158) are, by the provisions of section 912 (2), excluded from gross income.

WESTERN HEMISPHERE TRADE CORPORATIONS

§ 1.921 Statutory provisions; definition of Western Hemisphere trade corporations.

SEC. 921. *Definitions of Western Hemisphere trade corporations.* For purposes of this subtitle, the term "Western Hemisphere trade corporation" means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:

(1) If 95 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and

(2) If 90 percent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

For any taxable year beginning prior to January 1, 1954, the determination as to whether any corporation meets the requirements of section 109 of the Internal Revenue Code of 1939 shall be made as if this section had not been enacted and without inferences drawn from the fact that this section is not expressly made applicable with respect to taxable years beginning prior to January 1, 1954.

§ 1.921–1 Definition of Western Hemisphere trade corporation.

(a) *In general.* The term "Western Hemisphere trade corporation", for purposes of subtitle A of the Code, means a domestic corporation which meets all of the following tests:

(1) Its entire business for the taxable year is carried on within the Western Hemisphere. In determining whether this test is met, incidental purchases outside the Western Hemisphere will not disqualify the corporation. The term "incidental purchases" as used in section 921 and this section does not have the same meaning as the phrase "purchases incident to the conduct of the business". The term "incidental purchases" means only purchases (of any kind and for any purpose) which are (i) minor in relation to the entire business or (ii) nonrecurring or unusual in character. Whether purchases made outside the Western Hemisphere are incidental purchases for purposes of section 921 and this section shall be determined on the basis of all the facts of each particular case, except that in any case in which the aggregate of the purchases (of any kind and for any purpose) made outside the Western Hemisphere for the taxable year does not exceed an amount equal to 5 percent of the corporation's gross receipts from all sources for such taxable year, such purchases shall be deemed to be incidental purchases. Merely incidental economic contact with countries outside the Western Hemisphere will not disqualify a corporation as a Western Hemisphere trade corporation. For purposes of this section, the term "Western Hemisphere" means the countries in North, Central, and South America, and in the West Indies;

(2) Ninety-five percent or more of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) is derived from sources without the United States; and

(3) Ninety percent or more of its gross income for such period or such part thereof is derived from the active conduct of a trade or business. Dividends received by a corporation do not represent income derived from the active conduct of a trade or business.

(b) *Illustrations.* The application of the principles of paragraph (a) of this section may be illustrated by the following examples:

Example (1). X, a domestic corporation, operates a mine in South America and ships its products to England. The fact that X retains title to such goods until acceptance of the bill of lading and draft, solely in order to insure collection, will not cause X to be considered as carrying on business outside the Western Hemisphere, since such passing of title is merely an incidental economic contact outside the Western Hemisphere.

Example (2). Y, a domestic corporation, is engaged in Argentina in the business of manufacturing and selling construction equipment. During 1956, Y purchased in Germany certain motor parts required as an integral part of the equipment which it makes. The amount of such purchases equalled 4 percent of Y's gross receipts for 1956. Such purchases are incidental purchases and do not disqualify Y as a Western Hemisphere trade corporation.

Example (3). Z, a domestic corporation, operates a mine in South America. During 1956, Z, in accordance with its usual practices, purchased in France machinery and equipment necessary in the conduct of its business. The amount of such purchases was not minor in relation to Z's entire business. Such purchases disqualify Z as a Western Hemisphere trade corporation.

(c) *Statement required.* A corporation which claims to qualify as a Western Hemisphere trade corporation shall attach to its income tax return a statement showing: (1) That its entire business is done within the Western Hemisphere and, if any purchases are made outside the Western Hemisphere, the amount of such purchases, the amount of its gross receipts from all sources, and any other pertinent information, and (2) for the 3-year period immediately preceding the close of the taxable year (or for such part thereof during which the corporation was in existence), (i) its total gross income from all sources, (ii) the amount thereof derived from the active conduct of a trade or business, (iii) a description of such trade or business and the facts upon which the corporation relies to establish that such trade or business was actively conducted by it, and (iv) the amount of its gross income, if any, from sources within the United States. The gross income from sources within the United States and without the United States shall be determined as provided in Part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

§ 1.922 Statutory provisions; special deduction.

SEC. 922. *Special deduction.* In the case of a Western Hemisphere trade corporation there shall be allowed as a deduction in computing taxable income an amount computed as follows—

(1) First determine the taxable income of such corporation computed without regard to this section.

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) The numerator of which is 14 percent, and

(B) The denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

§ 1.922–1 Special deduction of Western Hemisphere trade corporation.

(a) A special deduction in computing taxable income in the case of a Western Hemisphere trade corporation (as defined in section 921) is allowed in section 922. The fraction specified in section 922 (2) is the same whether the amount of the corporation's taxable income is sufficient to subject it to the combined normal tax and surtax, or only to the normal tax. For the rules applicable in determining the special deduction where the alternative tax under section 1201 is imposed, see the regulations under section 1201.

(b) *Examples.* The computation of the special deduction may be illustrated by the following examples:

Example (1). A corporation which qualifies as a Western Hemisphere trade corporation realized gross income of $100,000 for the calendar year 1954 and had allowable deductions (other than the special deduction allowed by section 922) for that year in the amount of $40,000. The corporation normal tax rate and the surtax rate for the calendar year 1954 are 30 percent and 22 percent, respectively. The corporation's

special deduction under section 922 is $16,153.84, computed as follows:

(i) Compute the taxable income by subtracting allowable deductions of $40,000 from gross income of $100,000, with a result of $60,000.

(ii) The sum of the corporation normal tax rate and surtax rate for the calendar year 1954 is 52 percent (30 percent plus 22 percent). The fraction specified in section 922 (2), accordingly, is 14/52.

(iii) The amount of taxable income (subdivision (i)), $60,000, multiplied by the fraction determined under subdivision (ii), 14/52, is $16,153.84 (14/52 times $60,000).

Example (2). Assume that the facts are the same as in example (1) except that the allowable deductions (other than the special deductions allowed by section 922) are $80,000. The corporation's special deduction under section 922 is $5,384.61, computed as follows:

(i) Compute the taxable income by subtracting allowable deductions of $80,000 from gross income of $100,000, with a result of $20,000.

(ii) The sum of the corporation normal tax rate and surtax rate for the calendar year 1954 is 52 percent (30 percent plus 22 percent). The fraction specified in section 922 (2), accordingly, is 14/52, regardless of the fact that the taxable income of the corporation in the amount of $20,000 makes it subject only to the corporation normal tax.

(iii) The amount of taxable income (subdivision (i)), $20,000, multiplied by the fraction determined under subdivision (ii), 14/52, is $5,384.61 (14/52 times $20,000).

POSSESSIONS OF THE UNITED STATES

§ 1.931 Statutory provisions; income from sources within possessions of the United States.

SEC. 931. *Income from sources within possessions of the United States*—(a) *General rule.* In the case of citizens of the United States or domestic corporations, gross income means only gross income from sources within the United States if the conditions of both paragraph (1) and paragraph (2) are satisfied:

(1) *Three-year period.* If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) *Trade or business.* If—

(A) In the case of such corporation, 50 percent or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(B) In the case of such citizen, 50 percent or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) *Amounts received in United States.* Notwithstanding subsection (a), there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) *Definition.* For purposes of this section, the term "possession of the United States" does not include the Virgin Islands of the United States, and such term when used with respect to citizens of the United States does not include Puerto Rico.

(d) *Deductions.* (1) Citizens of the United States entitled to the benefits of this section shall have the same deductions as are allowed by section 873 in the case of a nonresident alien individual engaged in trade or business within the United States.

(2) Domestic corporations entitled to the benefits of this section shall have the same deductions as are allowed by section 882 (c) in the case of a foreign corporation engaged in trade or business within the United States.

(e) *Deduction for personal exemption.* A citizen of the United States entitled to the benefits of this section shall be allowed a deduction for only one exemption under section 151.

(f) *Allowance of deductions and credits.* Persons entitled to the benefits of this section shall receive the benefit of the deductions and credits allowed to them in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return of their total income received from all sources in the United States, in the manner prescribed in subtitle F, including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits.

(g) *Foreign tax credit.* Persons entitled to the benefits of this section shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(h) *Internees.* In the case of a citizen of the United States interned by the enemy while serving as an employee within a possession of the United States—

(1) If such citizen was confined in any place not within a possession of the United States, such place of confinement shall, for purposes of this section, be considered as within a possession of the United States; and

(2) Subsection (b) shall not apply to any compensation received within the United States by such citizen attributable to the period of time during which such citizen was interned by the enemy.

(i) *Employees of the United States.* For purposes of this section, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

§ 1.931–1 Citizens of the United States and domestic corporations deriving income from sources within a certain possession of the United States.

(a) *Definitions.* (1) As used in section 931 and this section, the term "possession of the United States" includes the Panama Canal Zone, Guam, American Samoa, Wake, and the Midway Islands, and Puerto Rico when used with respect to domestic corporations. The term does not include the Virgin Islands, nor does it include Puerto Rico when used with respect to citizens of the United States.

(2) As used in section 931 and this section, the term "United States" includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

(b) *General rule*—(1) *Qualifications.* In the case of a citizen of the United States or a domestic corporation satisfying the following conditions, gross income means only gross income from sources within the United States—

(i) If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States, and

(ii) If 50 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of section 931) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States. In the case of a citizen, the trade or business may be conducted on his own account or as an employee or agent of another. The salary or other compensation paid by the United States to the members of its civil, military, or naval personnel for services rendered within a possession of the United States represents income derived from the active conduct of a trade or business within a possession of the United States. The salary or other compensation paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall, for the purposes of section 931 and this section, be deemed to be derived from sources within the United States. Dividends received by a citizen from a corporation whose income was derived from the active conduct of a business within a possession of the United States, does not represent income derived from the active conduct of a trade or business within the possession of the United States even though such citizen was actively engaged in the management of such corporation. For a determination of income from sources within the United States, see part I (section 861 and following), subchapter N, chapter 1 of the Code, and section 931(i), and the regulations thereunder.

(2) *Relationship of sections 931 and 911.* A citizen of the United States who cannot meet the 80-percent and the 50-percent requirements of section 931 but who receives earned income from sources within a possession of the United States, is not deprived of the benefits of the provisions of section 911 (relating to the exemption of earned income from sources outside the United States), provided he meets the requirements thereof. In such a case none of the provisions of section 931 is applicable in determining the citizen's tax liability. For what constitutes earned income, see section 911 (b).

(3) *Meaning of "gross income" on joint return.* In the case of a husband and wife making a joint return, the term "gross income," as used in this section, means the combined gross income of the spouses.

(4) *Returns.* A citizen entitled to the benefits of section 931 is required to file with his individual return Form 1040 the schedule on Form 1040E. If a citizen entitled to the benefits of section 931 has no income from sources within the United States and does not receive within the United States any income derived from sources without the United States he is not required to file a return or the schedule on Form 1040E.

(5) *Illustration of the operation of section 931.* This section may be illustrated by the following example:

Example. On July 1, 1954, A, who is a citizen of the United States, went to a possession of the United States and established a business there which he actively conducted during the remainder of that year. His gross income from the business during such period was $20,000. In addition, he made a profit of $12,000 from the sale during the latter part of 1954 of some real estate located in such possession and not connected with his trade or business. In the first six months of 1954 he also derived $8,000 gross income from rental property located in the United States. He derived a like amount of gross income from such property during the last six months of 1954. On these facts, A may exclude the $32,000 derived from sources within the possession of the United States, since he qualified under section 931 with respect to that amount. The period of July 1, 1954, through December 31, 1954, constitutes the applicable part of the 3-year period immediately preceding the close of the taxable year (the calendar year 1954), and for that period, 80 percent of A's gross income was derived from sources within a possession of the United States ($32,000, or 80 percent of $40,000) and 50 percent or more of A's gross income was derived from the active conduct of a trade or business within a possession of the United States ($20,000, or 50 percent of $40,000). A is required to report on his return for 1954 only the gross income derived by him from sources within the United States ($16,000 from the rental property located in the United States).

(c) *Amounts received in the United States.* Notwithstanding the provisions of section 931 (a), there shall be included in the gross income of citizens and domestic corporations therein specified all amounts, whether derived from sources within or without the United States, which are received by such citizens or corporations within the United States. From the amounts so included in gross income there shall be deducted only the expenses properly apportioned or allocated thereto. For instance, if in the example set forth in paragraph (b) (5) of this section, the taxpayer during the latter part of 1954 returned to the United States for a few weeks and while there received the proceeds resulting from the sale of the real estate located in the possession, the profits derived from such transaction should be reported in gross income. Such receipt in the United States, however, would not deprive the taxpayer of the benefits of section 931 with respect to other items of gross income excluded by that section.

(d) *Deductions*—(1) *Individuals.* In the case of a citizen entitled to the benefits of section 931, the deductions allowed in computing taxable income, except the standard deduction and a deduction for one personal exemption (see sections 142 (b) (2) and 931 (e), respectively), are allowed only if and to the extent that they are connected with income from sources within the United States. The provisions of section 873 and the regulations thereunder, relating to the allowance to nonresident alien individuals, who at any time within the taxable year were engaged in trade or business within the United States, of the deductions provided in section 165 (c) (2) and (3) for losses not connected with the trade or business, are applicable in the case of citizens entitled to the benefits of section 931. The provisions of section 873 (c) and the regulations thereunder pertaining to the allowance to such nonresident alien individuals of deductions for contributions provided in section 170 are also applied in the case of such citizens.

(2) *Corporations.* Corporations entitled to the benefits of section 931 are allowed the same deductions from their gross income arising from sources within the United States as are allowed to domestic corporations to the extent that such deductions are connected with such gross income, except that the so-called charitable contribution deduction provided by section 170 to corporations is allowed whether or not connected with income from sources within the United States. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(e) *Deduction for personal exemption.* A citizen of the United States entitled to the benefits of section 931 is allowed a deduction for only one exemption under section 151.

(f) *Allowance of deductions and credits.* Unless a citizen of the United States or a domestic corporation entitled to the benefits of section 931 shall file or cause to be filed with the district director a true and accurate return of total income from all sources within the United States, in the manner prescribed in subtitle F of the Code, the tax shall be collected on the basis of the gross income (not the taxable income) from sources within the United States. If such citizen or corporation fails to file a necessary income tax return, the Commissioner will cause a return to be made, including therein all income from sources within the United States and allowing no deductions or credits (except credit for tax withheld at source).

(g) *Foreign tax credit.* Persons entitled to the benefits of section 931 are not allowed the credits provided for in section 901 (relating to credits for taxes of foreign countries and possessions).

(h) *Internees.* If a citizen of the United States—

(1) Was interned by the enemy while serving as an employee within a possession of the United States; and

(2) Was confined in any place not within a possession of the United States, then

(i) Such place of confinement shall be considered as within a possession of the United States for the purposes of section 931; and

(ii) Section 931 (b) shall not apply to any compensation received within the United States by such citizen attributable to the period of time during which such citizen was interned by the enemy.

(i) *Employees of the United States.* For the purposes of section 931, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

§ 1.932 Statutory provisions; taxation of citizens of possessions of the United States.

SEC. 932. *Citizens of possessions of the United States*—(a) *General rule.* Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States shall be subject to taxation under this subtitle only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources. This section shall have no application in the case of a citizen of Puerto Rico.

(b) *Virgin Islands.* Nothing in this section shall be construed to alter or amend the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes", approved July 12, 1921 (48 U. S. C. 1397), relating to the imposition of income taxes in the Virgin Islands of the United States.

(c) *Guam.* For applicability of United States income tax laws in Guam, see section 31 of the Act of August 1, 1950 (48 U. S. C. 1421i); for disposition of the proceeds of such taxes, see section 30 of such Act (48 U. S. C. 1421h).

§ 1.932–1 Status of citizens of United States possessions.

(a) *General rule*—(1) *Definition and treatment.* A citizen of a possession of the United States (except Puerto Rico), who is not otherwise a citizen or resident of the United States, including only the States and the District of Columbia, is treated for the purpose of the tax as if he were a nonresident alien individual. For purposes of the tax imposed by chapter 2 of the Code, the preceding sentence shall have no application to citizens of the Virgin Islands. See subpart A (section 871 and following), part II, subchapter N, chapter 1 of the Code, and the regulations thereunder, for rules relating to imposition of tax on nonresident alien individuals. For Federal income tax purposes, a citizen of a possession of the United States who is not otherwise a citizen of the United States is a citizen of a possession of the United States who has not become a citizen of the United States by naturalization. The fixed or determinable annual or periodical income from sources within the United States of a citizen of a possession of the United States who is treated as if he were a nonresident alien individual is subject to withholding. See section 1441.

(2) *Classification of citizens of United States possessions.* For the purpose of this section citizens of the possessions of the United States who are not otherwise citizens of the United States are divided into two classes: (i) Citizens of possessions of the United States who at any time within the taxable year are not engaged in trade or business within the United States, and (ii) citizens of possessions of the United States who at any time within the taxable year are engaged in trade or business within the United States. The provisions of subpart A (section 871 and following) and the regulations thereunder, applicable to nonresident alien individuals not engaged in trade or business within the United States are applicable to the citizens of posses-

sions falling within the first class, while the provisions of such sections applicable to nonresident alien individuals who at any time within the taxable year are engaged in trade or business within the United States are applicable to citizens of possessions falling within the second class.

(b) *No application to citizen of Puerto Rico.* The provisions of section 932 (a) and this section shall have no application in the case of a citizen of Puerto Rico.

§ 1.933 Statutory provisions; income from sources within Puerto Rico.

SEC. 933. *Income from sources within Puerto Rico.* The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) *Resident of Puerto Rico for entire taxable year.* In the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico (except amounts received for services performed as an employee of the United States or any agency thereof); but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction under section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) *Taxable year of change of residence from Puerto Rico.* In the case of an individual citizen of the United States who has been a bona fide resident of Puerto Rico for a period of at least 2 years before the date on which he changes his residence from Puerto Rico, income derived from sources therein (except amounts received for services performed as an employee of the United States or any agency thereof) which is attributable to that part of such period of Puerto Rican residence before such date; but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction for personal exemptions under section 151) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

§ 1.933–1 Exclusion of certain income from sources within Puerto Rico.

(a) *General rule.* An individual (whether a United States citizen or an alien), who is a bona fide resident of Puerto Rico during the entire taxable year, shall exclude from his gross income the income derived from sources within Puerto Rico, except amounts received for services performed as an employee of the United States or any agency thereof. Whether the individual is a bona fide resident of Puerto Rico shall be determined in general by applying to the facts and circumstances in each case the principles of §§ 1.871–2, 1.871–3, 1.871–4, and 1.871–5, relating to what constitutes residence or nonresidence, as the case may be, in the United States in the case of an alien individual. Once bona fide residence in Puerto Rico has been established, temporary absence therefrom in the United States or elsewhere on vacation or business trips will not necessarily deprive an individual of his status as a bona fide resident of Puerto Rico. An individual taking up residence in Puerto Rico during the course of the taxable year is not entitled for such year to the exclusion provided in section 933.

(b) *Taxable year of change of residence from Puerto Rico.* A citizen of the United States who changes his residence from Puerto Rico after having been a bona fide resident thereof for a period of at least two years immediately preceding the date of such change in residence shall exclude from his gross income the income derived from sources within Puerto Rico which is attributable to that part of such period of Puerto Rican residence which preceded the date of such change in residence, except amounts received for services performed as an employee of the United States or any agency thereof.

(c) *Deductions.* In any case in which any amount otherwise constituting gross income is excluded from gross income under the provisions of section 933, there shall not be allowed as a deduction from gross income any items of expenses or losses or other deductions (except the deduction under section 151, relating to personal exemptions) properly allocable to, or chargeable against, the amounts so excluded from gross income.

CHINA TRADE ACT CORPORATIONS

§ 1.941 Statutory provisions; special deduction for China Trade Act corporations.

SEC. 941. *Special deduction for China Trade Act corporations*—(a) *Allowance of deduction.* For purposes only of the taxes imposed by section 11, there shall be allowed, in the case of a corporation organized under the China Trade Act, 1922 (15 U. S. C. ch. 4, sec. 141 and following), in addition to the deductions from taxable income otherwise allowed such corporation, a special deduction, in computing the taxable income, of an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a similar manner to that provided in part I) which the par value of the shares of stock of the corporation owned on the last day of the taxable year by—

(1) Persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and

(2) Individual citizens of the United States wherever resident,

bears to the par value of the whole number of shares of stock of the corporation outstanding on such date. In no case shall the diminution, by reason of such special deduction, of the taxes imposed by section 11 (computed without regard to this section) exceed the amount of the special dividend certified under subsection (b) of this section.

(b) *Special dividend.* The special deduction provided in subsection (a) shall not be allowed unless the Secretary of Commerce has certified to the Secretary of the Treasury or his delegate—

(1) The amount which, during the year ending on the date fixed by law for filing the return, the corporation has distributed as a special dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation;

(2) That such special dividend was in addition to all other amounts, payable or to be payable to such persons or for their benefit, by reason of their interest in the corporation; and

(3) That such distribution has been made to or for the benefit of such persons in proportion to the par value of the shares of stock of the corporation owned by each; except that if the corporation has more than one class of stock, the certificates shall contain a statement that the articles of incorporation provide a method for the apportionment of such special dividend among such persons, and that the amount certified has been distributed in accordance with the method so provided.

(c) *Ownership of stock.* For purposes of this section, shares of stock of a corporation shall be considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

§ 1.941–1 Special deduction for China Trade Act corporations.

In addition to the deductions from taxable income otherwise allowed such a corporation, a China Trade Act corporation is, under certain conditions, allowed an additional deduction in computing taxable income. This special deduction is an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a manner similar to that provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder) which the par value of the shares of stock of the corporation, owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease, by reason of such deduction, in the tax imposed by section 11 must not, however, exceed the amount of the special dividend referred to in section 941 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce.

§ 1.941–2 Meaning of terms used in connection with China Trade Act corporations.

(a) A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922 (15 U.S.C., ch. 4).

(b) The term "special dividend" means the amount which is distributed as a dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation. Such dividend must be distributed prior to or at the time fixed by law for filing the return of the corporation, including the period of any extension of time granted under rules and regulations prescribed by the Commissioner with the approval of the Secretary or his delegate. Such special dividend does not include any other amounts payable or to be payable to such persons or for their benefit by reason of their interest in the corporation and must be made in proportion to the par value of the shares of stock of the corporation owned by each.

(c) For the purposes of section 941, the shares of stock of a China Trade Act

corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) "Taxable income derived from sources within Formosa and Hong Kong" is the sum of the taxable income from sources wholly within Formosa and Hong Kong and that portion of the taxable income from sources partly within and partly without Formosa and Hong Kong which may be allocated to sources within Formosa and Hong Kong. The method of computing this income is similar to that described in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

§ 1.941–3 Illustration of principles.

The application of section 941 may be illustrated by the following example:

Example. (1) The A Company, a China Trade Act corporation, has taxable income (computed without regard to the deduction under section 941) for the calendar year 1954 of $200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1954, is owned on that date by persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, or individual citizens of the United States. It distributes a special dividend amounting to $100,000 on February 15, 1955, which is certified by the Secretary of Commerce as provided in section 941 (b). For the purpose of the tax imposed by section 11, it is necessary in this example to make two computations, first, without allowing the special deduction from taxable income on account of income derived from sources within Formosa and Hong Kong, and, second, allowing such deduction. The computations are as follows:

(2) First computation; without allowing the special deduction from taxable income.

Taxable income	$200,000
Normal tax (section 11 (b))	60,000
Surtax (section 11 (c))	38,500
Total income tax	98,500

(3) Second computation; allowing the special deduction from taxable income.

Taxable income	$200,000

Since the total taxable income is derived from sources within Formosa and Hong Kong and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of such taxable income is deductible.

Special deduction from taxable income	$200,000
Amount of income subject to tax under section 11	None

(4) Since the special dividend ($100,000) exceeds the diminution of the tax ($98,500) on account of the allowance of the special deduction from taxable income, the entire amount of the special deduction is allowable and the corporation has no income tax liability for 1954.

§ 1.942 Statutory provisions; disallowance of foreign tax credit.

SEC. 942. *Disallowance of foreign tax credit.* A corporation organized under the China Trade Act, 1922, shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

§ 1.943 Statutory provisions; exclusion of dividends to residents of Formosa or Hong Kong.

SEC. 943. *Exclusion of dividends to residents of Formosa or Hong Kong.* Amounts distributed as dividends to or for the benefit of any person by a corporation organized under the China Trade Act, 1922, shall not be included in gross income and shall be exempt from taxation under this subtitle if, at the time of such distribution, such person is a resident of Formosa or Hong Kong, and the equitable right to the income of the shares of stock of the corporation is in good faith vested in him.

§ 1.943–1 Withholding by a China Trade Act corporation.

Dividends distributed by a China Trade Act corporation which are treated as income from sources within the United States under the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder are subject to withholding at the rate of 30 percent when paid to persons (other than residents of Formosa and Hong Kong) who are (a) nonresident aliens, (b) nonresident partnerships composed in whole or in part of nonresident aliens, or (c) nonresident foreign corporations. The 30 percent rate of withholding specified in this section with respect to dividends shall be reduced to such rate as may be provided by treaty with any country. See section 1441 and the regulations thereunder.

GAIN OR LOSS ON DISPOSITION OF PROPERTY

DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

§ 1.1001 Statutory provisions; determination of amount of and recognition of gain or loss.

SEC. 1001. *Determination of amount of and recognition of gain or loss.*—(a) *Computation of gain or loss.* The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.* The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) There shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164 (d) as imposed on the purchaser, and

(2) There shall be taken into account amounts representing real property taxes which are treated under section 164 (d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) *Recognition of gain or loss.* In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

(d) *Installment sales.* Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

§ 1.1001–1 Computation of gain or loss.

(a) *General rule.* Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001, which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and regulations thereunder (i.e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder.

(b) *Real estate taxes as amounts received.* (1) Section 1001 (b) and section 1012 state rules applicable in making an adjustment upon a sale of real property with respect to the real property taxes apportioned between seller and purchaser under section 164 (d). Thus, if the seller pays (or agrees to pay) real property taxes attributable to the real property tax year in which the sale occurs, he shall not take into account, in determining the amount realized from the sale under section 1001 (b), any amount received as reimbursement for taxes which are treated under section 164 (d) as imposed upon the purchaser. Similarly, in computing the cost of the property under section 1012, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164 (d) as imposed upon the purchaser. These rules apply whether or not the contract of sale calls for the purchaser to reimburse the seller for such real property taxes paid or to be paid by the seller.

(2) On the other hand, if the purchaser pays (or is to pay) an amount representing real property taxes which are treated under section 164 (d) as imposed upon the seller, that amount shall be taken into account both in determining the amount realized from the sale under section 1001 (b) and in computing the cost of the property under

section 1012. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, the taxes allocable to the seller. See also paragraph (b) of § 1.1012–1.

(3) Subparagraph (1) of this paragraph shall not apply to a seller who, in a taxable year prior to the taxable year of sale, pays an amount representing real property taxes which are treated under section 164 (d) as imposed on the purchaser, if such seller has elected to capitalize such amount in accordance with section 266 and the regulations thereunder (relating to election to capitalize certain carrying charges and taxes).

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). Assume that the contract price on the sale of a parcel of real estate is $50,000 and that real property taxes thereon in the amount of $1,000 for the real property tax year in which occurred the date of sale were previously paid by the seller. Assume further that $750 of the taxes are treated under section 164 (d) as imposed upon the purchaser and that he reimburses the seller in that amount in addition to the contract price. The amount realized by the seller is $50,000. Similarly, $50,000 is the purchaser's cost. If, in this example, the purchaser made no payment other than the contract price of $50,000, the amount realized by the seller would be $49,250, since the sales price would be deemed to include $750 paid to the seller in reimbursement for real property taxes imposed upon the purchaser. Similarly, $49,250 would be the purchaser's cost.

Example (2). Assume that the purchaser in example (1), above, paid all of the real property taxes. Assume further that $250 of the taxes are treated under section 164 (d) as imposed upon the seller. The amount realized by the seller is $50,250. Similarly, $50,250 is the purchaser's cost, regardless of the taxable year in which the purchaser makes actual payment of the taxes.

Example (3). Assume that the seller described in the first part of example (1), above, paid the real property taxes of $1,000 in the taxable year prior to the taxable year of sale and elected under section 266 to capitalize the $1,000 of taxes. In such a case, the amount realized is $50,750. Moreover, regardless of whether the seller elected to capitalize the real property taxes, the purchaser in that case could elect under section 266 to capitalize the $750 of taxes treated under section 164 (d) as imposed upon him, in which case his adjusted basis would be $50,750 (cost of $50,000 plus capitalized taxes of $570).

(c) *Other rules.* (1) Even though property is not sold or otherwise disposed of, gain is realized if the sum of all the amounts received which are required by section 1016 and other applicable provisions of subtitle A of the Code to be applied against the basis of the property exceeds such basis. Except as otherwise provided in section 301(c)(3)(B) with respect to distributions out of increase in value of property accrued prior to March 1, 1913, such gain is includible in gross income under section 61 as "income from whatever source derived". On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, it is not taken into account.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. A, an individual on a calendar year basis, purchased certain shares of stock subsequent to February 28, 1913, for $10,000. On January 1, 1954, A's adjusted basis for the stock had been reduced to $1,000 by reason of receipts and distributions described in sections 1016 (a) (1) and 1016 (a) (4). He received in 1954 a further distribution of $5,000, being a distribution covered by section 1016 (a) (4), other than a distribution out of increase of value of property accrued prior to March 1, 1913. This distribution applied against the adjusted basis as required by section 1016 (a) (4) exceeds that basis by $4,000. The $4,000 excess is a gain realized by A in 1954 and is includible in gross income in his return for that calendar year. In computing gain from the stock, as in adjusting basis, no distinction is made between items of receipts or distributions described in section 1016. If A sells the stock in 1955 for $5,000, he realizes in 1955 a gain of $5,000, since the adjusted basis of the stock for the purpose of computing gain or loss from the sale is zero.

(d) *Installment sales.* In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 453.

(e) *Transfers in part a sale and in part a gift.* (1) Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For determination of basis of the property in the hands of the transferee, see § 1.1015–4.

(2) *Examples.* The provisions of subparagraph (1) may be illustrated by the following examples:

Example (1). A transfers property to his son for $60,000. Such property in the hands of A has an adjusted basis of $30,000 (and a fair market value of $90,000). A's gain is $30,000, the excess of $60,000, the amount realized, over the adjusted basis, $30,000. He has made a gift of $30,000, the excess of $90,000, the fair market value, over the amount realized, $60,000.

Example (2). A transfers property to his son for $30,000. Such property in the hands of A has an adjusted basis of $60,000 (and a fair market value of $90,000). A has no gain or loss, and has made a gift of $60,000, the excess of $90,000, the fair market value, over the amount realized, $30,000.

Example (3). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $30,000 (and a fair market value of $60,000). A has no gain and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Example (4). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $90,000 (and a fair market value of $60,000). A has sustained no loss, and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

§ 1.1002 Statutory provisions; recognition of gain or loss.

SEC. 1002. *Recognition of gain or loss.* Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

§ 1.1002–1 Sales or exchanges.

(a) *General rule.* The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is recognized except in cases where specific provisions of subtitle A of the Code provide otherwise.

(b) *Strict construction of exceptions from general rule.* The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351 (a), 354, 361 (a), 371 (a) (1), 371 (b) (1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(d) *Exchange.* Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

BASIS RULES OF GENERAL APPLICATION

§ 1.1011 Statutory provisions; adjusted basis for determining gain or loss.

SEC. 1011. *Adjusted basis for determining gain or loss.* The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and ad-

justments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

§ 1.1011–1 Adjusted basis.

The adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost or other basis prescribed in section 1012 or other applicable provisions of subtitle A of the Code, adjusted to the extent provided in sections 1016, 1017, and 1018 or as otherwise specifically provided for under applicable provisions of internal revenue laws.

§ 1.1012 Statutory provisions; basis of property—cost.

SEC. 1012. *Basis of property—cost.* The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164 (d) as imposed on the taxpayer.

§ 1.1012–1 Basis of property.

(a) *General rule.* In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property. This general rule is subject to exceptions stated in subchapter O (relating to gain or loss on the disposition of property), subchapter C (relating to corporate distributions and adjustments), subchapter K (relating to partners and partnerships), and subchapter P (relating to capital gains and losses), chapter 1 of the Code.

(b) *Real estate taxes as part of cost.* In computing the cost of real property, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164 (d) as imposed upon the purchaser. This rule applies whether or not the contract of sale calls for the purchaser to reimburse the seller for such real estate taxes paid or to be paid by the seller. On the other hand, where the purchaser pays (or assumes liability for) real estate taxes which are treated under section 164 (d) as imposed upon the seller, such taxes shall be considered part of the cost of the property. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, real estate taxes allocable to the seller under section 164 (d). For illustrations of the application of this paragraph, see paragraph (b) of § 1.1001–1.

(c) *Sale of stock*—(1) *In general.* If shares of stock in a corporation are sold or transferred by a taxpayer who purchased or acquired lots of stock on different dates or at different prices, and the lot from which the stock was sold or transferred cannot be adequately identified, the stock sold or transferred shall be charged against the earliest of such lots purchased or acquired in order to determine the cost or other basis of such stock and in order to determine the holding period of such stock for purposes of subchapter P, chapter 1 of the Code. If, on the other hand, the lot from which the stock is sold or transferred can be adequately identified, the rule stated in the preceding sentence is not applicable. As to what constitutes "adequate identification", see subparagraphs (2), (3), and (4) of this paragraph.

(2) *Identification of stock.* An adequate identification is made if it is shown that certificates representing shares of stock from a lot which was purchased or acquired on a certain date or for a certain price were delivered to the taxpayer's transferee. Except as otherwise provided in subparagraph (3) or (4) of this paragraph, such stock certificates delivered to the transferee constitute the stock sold or transferred by the taxpayer. Thus, unless the requirements of subparagraph (3) or (4) of this paragraph are met, the stock sold or transferred is charged to the lot to which the certificates delivered to the transferee belong, whether or not the taxpayer intends, or instructs his broker or other agent, to sell or transfer stock from a lot purchased or acquired on a different date or for a different price.

(3) *Identification on confirmation document.* (i) Where the stock is left in the custody of a broker or other agent, an adequate identification is made if—

(*a*) At the time of the sale or transfer, the taxpayer specifies to such broker or other agent having custody of the stock the particular stock to be sold or transferred, and

(*b*) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or other agent.

Stock identified pursuant to this subdivision is the stock sold or transferred by the taxpayer, even though stock certificates from a different lot are delivered to the taxpayer's transferee.

(ii) Where a single stock certificate represents stock from different lots, where such certificate is held by the taxpayer rather than his broker or other agent, and where the taxpayer sells a part of the stock represented by such certificate through a broker or other agent, an adequate identification is made if—

(*a*) At the time of the delivery of the certificate to the broker or other agent, the taxpayer specifies to such broker or other agent the particular stock to be sold or transferred, and

(*b*) Within a reasonable time thereafter, confirmation of such specification is set forth in a written document from such broker or agent.

Where part of the stock represented by a single certificate is sold or transferred directly by the taxpayer to the purchaser or transferee instead of through a broker or other agent, an adequate identification is made if the taxpayer maintains a written record of the particular stock which he intended to sell or transfer.

(4) *Stock held by a trustee, executor, or administrator.* Where stock is held by a trustee or by an executor or administrator of an estate (and not left in the custody of a broker or other agent), an adequate identification is made if at the time of a sale, transfer, or distribution, the trustee, executor, or administrator—

(i) Specifies in writing in the books and records of the trust or estate the particular stock to be sold, transferred, or distributed, and

(ii) In the case of a distribution, also furnishes the distributee with a written document setting forth the particular stock distributed to him.

Stock identified pursuant to this subparagraph is the stock sold, transferred, or distributed by the trust or estate, even though stock certificates from a different lot are delivered to the purchaser, transferee, or distributee.

(5) *Subsequent sales.* If stock identified under subparagraph (3) or (4) of this paragraph as belonging to a particular lot is sold, transferred, or distributed, the stock so identified shall be deemed to have been sold, transferred, or distributed, and such sale, transfer, or distribution will be taken into consideration in identifying the taxpayer's remaining stock for purposes of subsequent sales, transfers, or distributions.

(d) *Special rules.* For special rules for determining the basis for gain or loss in the case of vessels acquired through the Maritime Commission (or its successor), see sections 510 and 511 of the Merchant Marine Act of 1936 (46 U. S. C. 1160, 1161). For special rules for determining the unadjusted basis of property recovered in respect of war losses, see section 1336. For special rules for determining the basis for gain or loss in the case of the disposition of a share of stock acquired pursuant to the timely exercise of a restricted stock option where the option price was between 85 percent and 95 percent of the fair market value of the stock at the time the option was granted, see section 421 (b). For special rules for determining the basis and adjusted basis of property acquired or improved with the proceeds of a grant or loan made to a taxpayer by the United States for the encouragement of exploration, development, or mining of critical and strategic minerals or metals, see section 621.

§ 1.1012–2 Transfers in part a sale and in part a gift.

For rule relating to basis of property acquired in a transfer which is in part a gift and in part a sale, see § 1.1015–4.

§ 1.1013 Statutory provisions; basis of property included in inventory.

SEC. 1013. *Basis of property included in inventory.* If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

§ 1.1013–1 Property included in inventory.

The basis of property required to be included in inventory is the last inventory value of such property in the hands of the taxpayer. The requirements with respect to the valuation of an inventory are stated in subpart D (section 471 and following), part II, subchapter E, chapter 1 of the Code, and the regulations thereunder.

§ 1.1014 Statutory provisions; basis of property acquired from a decedent.

SEC. 1014. *Basis of property acquired from a decedent*—(a) *In general.* Except as otherwise provided in this section, the basis of property in the hands of a person acquir-

ing the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under either section 2032 or section 811 (j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections.

(b) *Property acquired from the decedent.* For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;

(2) Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;

(4) Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;

(5) In the case of decedents dying after August 26, 1937, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent's death or the basis in the hands of the decedent, whichever is lower;

(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

(7) In the case of decedents dying after October 21, 1942, and on or before December 31, 1947, such part of any property, representing the surviving spouse's one-half share of property held by a decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, as was included in determining the value of the gross estate of the decedent, if a tax under chapter 3 of the Internal Revenue Code of 1939 was payable on the transfer of the net estate of the decedent. In such case, nothing in this paragraph shall reduce the basis below that which would exist if the Revenue Act of 1948 had not been enacted;

(8) In the case of decedents dying after December 31, 1950, and before January 1, 1954, property which represents the survivor's interest in a joint and survivor's annuity if the value of any part of such interest was required to be included in determining the value of decedent's gross estate under section 811 of the Internal Revenue Code of 1939;

(9) In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Such basis shall be applicable to the property commencing on the death of the decedent. This parargaph shall not apply to—

(A) Annuities described in section 72;

(B) Property to which paragraph (5) would apply if the property had been acquired by bequest; and

(C) Property described in any other paragraph of this subsection.

(c) *Property representing income in respect of a decedent.* This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

(d) *Employee stock options.* This section shall not apply to restricted stock options described in section 421 which the employee has not exercised at death.

§ 1.1014–1 Basis of property acquired from a decedent.

(a) *General rule.* The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date prescribed in section 2032, or in section 811(j) of the Internal Revenue Code of 1939. Property acquired from a decedent includes, principally, property acquired by bequest, devise, or inheritance, and, in the case of decedents dying after December 31, 1953, property required to be included in determining the value of the decedent's gross estate under any provision of the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939. The general rule governing basis of property acquired from a decedent, as well as other rules prescribed elsewhere in this section, shall have no application if the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent. For general rules on the applicable valuation date where the executor of a decedent's estate elects under section 2032, or under section 811(j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections, see paragraph (c) of § 1.1014–3.

(b) *Scope and application.* With certain limitations, the general rule described in paragraph (a) of this section is applicable to the classes of property described in paragraphs (a) and (b) of § 1.1014–2. Special basis rules with respect to the basis of certain other property acquired from a decedent are set forth in paragraph (c) of § 1.1014–2. These special rules concern certain stock or securities of a foreign personal holding company and the surviving spouse's one-half share of community property held with a decedent dying after October 21, 1942, and on or before December 31, 1947. In this section and §§ 1.1014–2 to 1.1014–6, inclusive, whenever the words "property acquired from a decedent" are used, they shall also mean "property passed from a decedent", and the phrase "person who acquired it from the decedent" shall include the "person to whom it passed from the decedent."

(c) *Property to which section 1014 does not apply.* Section 1014 shall have no application to the following classes of property:

(1) Property which constitutes a right to receive an item of income in respect of a decedent under section 691; and

(2) Restricted stock options described in section 421 which the employee has not exercised at death, regardless of the date on which the employee died.

§ 1.1014–2 Property acquired from a decedent.

(a) *In general.* The following property, except where otherwise indicated, is considered to have been acquired from a decedent and the basis thereof is determined in accordance with the general rule in § 1.1014–1:

(1) Without regard to the date of the decedent's death, property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, whether the property was acquired under the decedent's will or under the law governing the descent and distribution of the property of decedents. However, see paragraph (c) (1) of this section if the property was acquired by bequest or inheritance from a decedent dying after August 26, 1937, and if such property consists of stock or securities of a foreign personal holding company.

(2) Without regard to the date of the decedent's death, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust.

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.

(4) Without regard to the date of the decedent's death, property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will. (See section 2041 (b) for definition of general power of appointment.)

(5) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in that property was includible in determining the value of the decedent's gross estate under part III, chapter 11 of the Internal Revenue Code of 1954 (relating to the estate tax) or section 811 of the Internal Revenue Code of 1939. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(6) In the case of decedents dying after December 31, 1950, and before January 1, 1954, property which represents the survivor's interest in a joint and survivor's annuity if the value of any part of that interest was required to be included in determining the value of the decedent's gross estate under section 811 of the Internal Revenue Code of 1939. It is necessary only that the value of a part of the survivor's interest in the annuity be includible in the gross estate under section 811. It is not necessary for the application of this subparagraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable.

(b) *Property acquired from a decedent dying after December 31, 1953*—(1) *In general.* In addition to the property described in paragraph (a) of this section, and except as otherwise provided in subparagraph (3) of this paragraph, in the case of a decedent dying after December 31, 1953, property shall also be considered to have been acquired from the decedent to the extent that both of the following conditions are met: (i) the property was acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), and (ii) the property is includible in the decedent's gross estate under the provisions of the Internal Revenue Code of 1954, or the Internal Revenue Code of 1939, because of such acquisition. The basis of such property in the hands of the person who acquired it from the decedent shall be determined in accordance with the general rule in § 1.1014–1. See, however, § 1.1014–6 for special adjustments if such property is acquired before the death of the decedent. See also subparagraph (3) of this paragraph for a description of property not within the scope of this paragraph.

(2) *Rules for the application of subparagraph (1) of this paragraph.* Except as provided in subparagraph (3) of this paragraph, this paragraph generally includes all property acquired from a decedent, which is includible in the gross estate of the decedent if the decedent died after December 31, 1953. It is not necessary for the application of this paragraph that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable. Property acquired prior to the death of a decedent which is includible in the decedent's gross estate, such as property transferred by a decedent in contemplation of death, and property held by a taxpayer and the decedent as joint tenants or as tenants by the entireties is within the scope of this paragraph. Also, this paragraph includes property acquired through the exercise or non-exercise of a power of appointment where such property is includible in the decedent's gross estate. It does not include property not includible in the decedent's gross estate such as property not situated in the United States acquired from a nonresident who is not a citizen of the United States.

(3) *Exceptions to application of this paragraph.* The rules in this paragraph are not applicable to the following property:

(i) Annuities described in section 72;

(ii) Stock or securities of a foreign personal holding company as described in section 1014 (b) (5) (see paragraph (c) (1) of this section);

(iii) Property described in any paragraph other than paragraph (9) of section 1014 (b). See paragraphs (a) and (c) of this section.

In illustration of subdivision (ii), assume that A acquired by gift stock of a character described in paragraph (c) (1) of this section from a donor and upon the death of the donor the stock was includible in the donor's estate as being a gift in contemplation of death. A's basis in the stock would not be determined by reference to its fair market value at the donor's death under the general rule in section 1014 (a). Furthermore, the special basis rules prescribed in paragraph (c) (1) of this section are not applicable to such property acquired by gift in contemplation of death. It will be necessary to refer to the rules in section 1015 (a) to determine the basis.

(c) *Special basis rules with respect to certain property acquired from a decedent*—(1) *Stock or securities of a foreign personal holding company.* The basis of certain stock or securities of a foreign corporation which was a foreign personal holding company with respect to its taxable year next preceding the date of the decedent's death is governed by a special rule. If such stock was acquired from a decedent dying after August 26, 1937, by bequest or inheritance, or by the decedent's estate from the decedent, the basis of the property in the hands of the person who so acquired it (notwithstanding any other provision of section 1014) shall be the fair market value of such property at the date of the decedent's death or the adjusted basis of the stock in the hands of the decedent, whichever is lower.

(2) *Spouse's interest in community property of decedent dying after October 21, 1942, and on or before December 31, 1947.* In the case of a decedent dying after October 21, 1942, and on or before December 31, 1947, a special rule is provided for determining the basis of such part of any property, representing the surviving spouse's one-half share of property held by the decedent and the surviving spouse under the community property laws of any State, Territory, or possession of the United States or any foreign country, as was included in determining the value of the decedent's gross estate, if a tax under chapter 3 of the Internal Revenue Code of 1939 was payable upon the decedent's net estate. In such case the basis shall be the fair market value of such part of the property at the date of death (or the optional valuation elected under section 811 (j) of the Internal Revenue Code of 1939) or the adjusted basis of the property determined without regard to this subparagraph, whichever is the higher.

§ 1.1014–3 Other basis rules.

(a) *Fair market value.* For purposes of this section and § 1.1014–1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

(b) *Property acquired from a decedent dying before March 1, 1913.* If the decedent died before March 1, 1913, the fair market value on that date is taken in lieu of the fair market value on the date of death, but only to the same extent and for the same purposes as the fair market value on March 1, 1913, is taken under section 1053.

(c) *Reinvestments by a fiduciary.* The basis of property acquired after the death of the decedent by a fiduciary as an investment is the cost or other basis of such property to the fiduciary, and not the fair market value of such property at the death of the decedent. For example, the executor of an estate purchases stock of X company at a price of $100 per share with the proceeds of the sale of property acquired from a decedent. At the date of the decedent's death the fair market value of such stock was $98 per share. The basis of such stock to the executor or to a legatee, assuming the stock is distributed, is $100 per share.

(d) *Reinvestments of property transferred during life.* Where property is transferred by a decedent during life and the property is sold, exchanged, or otherwise disposed of before the decedent's death by the person who acquired the property from the decedent, the general rule stated in paragraph (a) of § 1.1014–1 shall not apply to such property. However, in such a case, the basis of any property acquired by such donee in exchange for the original property, or of any property acquired by the donee through reinvesting the proceeds of the sale of the original property, shall be the fair market value of the property thus acquired at the date of the decedent's death (or applicable alternate valuation date) if the property thus

acquired is properly included in the decedent's gross estate for Federal estate tax purposes. These rules also apply to property acquired by the donee in any further exchanges or in further reinvestments. For example, on January 1, 1956, the decedent made a gift of real property to a trust for the benefit of his children, reserving to himself the power to revoke the trust at will. Prior to the decedent's death, the trustee sold the real property and invested the proceeds in stock of the Y company at $50 per share. At the time of the decedent's death, the value of such stock was $75 per share. The corpus of the trust was required to be included in the decedent's gross estate owing to his reservation of the power of revocation. The basis of the Y company stock following the decedent's death is $75 per share. Moreover, if the trustee sold the Y Company stock before the decedent's death for $65 a share and reinvested the proceeds in Z company stock which increased in value to $85 per share at the time of the decedent's death, the basis of the Z company stock following the decedent's death would be $85 per share.

(e) *Alternate valuation dates.* Section 1014 (a) provides a special rule applicable in determining the basis of property described in § 1.1014–2 where—

(1) The property is includible in the gross estate of a decedent who died after October 21, 1942, and

(2) The executor elects for estate tax purposes under section 2032, or section 811 (j) of the Internal Revenue Code of 1939, to value the decedent's gross estate at the alternate valuation date prescribed in such sections.

In those cases, the value applicable in determining the basis of the property is not the value at the date of the decedent's death but (with certain limitations) the value at the date one year after his death if not distributed, sold, exchanged, or otherwise disposed of in the meantime. If such property was distributed, sold, exchanged, or otherwise disposed of within one year after the date of the decedent's death by the person who acquired it from the decedent, the value applicable in determining the basis is its value as of the date of such distribution, sale, exchange, or other disposition. For illustrations of the operation of this paragraph, see the estate tax regulations under section 2032.

§ 1.1014–4 Uniformity of basis; adjustment to basis.

(a) *In general.* (1) The basis of property acquired from a decedent, as determined under section 1014(a), is uniform in the hands of every person having possession or enjoyment of the property at any time under the will or other instrument or under the laws of descent and distribution. The principle of uniform basis means that the basis of the property (to which proper adjustments must, of course, be made) will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust. In determining the amount allowed or allowable to a taxpayer in computing taxable income as deductions for depreciation or depletion under section 1016(a)(2), the uniform basis of the property shall at all times be used and adjusted. The sale, exchange, or other disposition by a life tenant or remainderman of his interest in property will, for purposes of this section, have no effect upon the uniform basis of the property in the hands of those who acquired it from the decedent. Thus, gain or loss on sale of trust assets by the trustee will be determined without regard to the prior sale of any interest in the property. Moreover, any adjustment for depreciation shall be made to the uniform basis of the property without regard to such prior sale, exchange, or other disposition.

(2) Under the law governing wills and the distribution of the property of decedents, all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of the person taking the title was, at the date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise. Accordingly, there is a common acquisition date for all titles to property acquired from a decedent within the meaning of section 1014, and, for this reason, a common or uniform basis for all such interests. For example, if distribution of personal property left by a decedent is not made until one year after his death, the basis of such property in the hands of the legatee is its fair market value at the time when the decedent died, and not when the legatee actually received the property. If the bequest is of the residue to trustees in trust, and the executors do not distribute the residue to such trustees until five years after the death of the decedent, the basis of each piece of property left by the decedent and thus received, in the hands of the trustees, is its fair market value at the time when the decedent dies. If the bequest is to trustees in trust to pay to A during his lifetime the income of the property bequeathed, and after his death to distribute such property to the survivors of a class, and upon A's death the property is distributed to the taxpayer as the sole survivor, the basis of such property, in the hands of the taxpayer, is its fair market value at the time when the decedent died. The purpose of the Code in prescribing a general uniform basis rule for property acquired from a decedent is, on the one hand, to tax the gain, in respect of such property, to him who realizes it (without regard to the circumstances that at the death of the decedent it may have been quite uncertain whether the taxpayer would take or gain anything); and, on the other hand, not to recognize as gain any element of value resulting solely from the circumstance that the possession or enjoyment of the taxpayer was postponed. Such postponement may be, for example, until the administration of the decedent's estate is completed, until the period of the possession or enjoyment of another has terminated, or until an uncertain event has happened. It is the increase or decrease in the value of property reflected in a sale or other disposition which is recognized as the measure of gain or loss.

(3) The principles stated in subparagraphs (1) and (2) of this paragraph do not apply to property transferred by an executor, administrator or trustee, to an heir, legatee, devisee or beneficiary under circumstances such that the transfer constitutes a sale or exchange. In such a case, gain or loss must be recognized by the transferor to the extent required by the revenue laws, and the transferee acquires a basis equal to the fair market value of the property on the date of the transfer. Thus, for example, if the trustee of a trust created by will transfers to a beneficiary, in satisfaction of a specific bequest of $10,000, securities which had a fair market value of $9,000 on the date of the decedent's death (the applicable valuation date) and $10,000 on the date of the transfer, the trust realizes a taxable gain of $1,000 and the basis of the securities in the hands of the beneficiary would be $10,000. As a further example, if the executor of an estate transfers to a trust property worth $200,000, which had a fair market value of $175,000 on the date of the decedent's death (the applicable valuation date), in satisfaction of the decedent's bequest in trust for the benefit of his wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction), capital gain in the amount of $25,000 would be realized by the estate and the basis of the property in the hands of the trustees would be $200,000. If, on the other hand, the decedent bequeathed a fraction of his residuary estate to a trust for the benefit of his wife, which fraction will not change regardless of any fluctuations in value of property in the decedent's estate after his death, no gain or loss would be realized by the estate upon transfer of property to the trust, and the basis of the property in the hands of the trustee would be its fair market value on the date of the decedent's death or on the alternate valuation date.

(b) *Multiple interests.* Where more than one person has an interest in property acquired from a decedent, the basis of such property shall be determined and adjusted without regard to the multiple interests. The basis for computing gain or loss on the sale of any one of such multiple interests shall be determined under § 1.1014–5. Thus, the deductions for depreciation and for depletion allowed or allowable, under sections 167 and 611, to a legal life tenant as if the life tenant were the absolute owner of the property, constitute an adjustment to the basis of the property not only in the hands of the life tenant, but also in the hands of the remainderman and every other person to whom the same uniform basis is applicable. Similarly, the deductions allowed or allowable under sections 167 and 611, both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but also in the hands of the

trust beneficiaries and every other person to whom the uniform basis is applicable. See, however, section 262. Similarly, adjustments in respect of capital expenditures or losses, tax-free distributions, or other distributions applicable in reduction of basis, or other items for which the basis is adjustable are made without regard to which one of the persons to whom the same uniform basis is applicable makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable. See § 1.1014–6 for adjustments in respect of property acquired from a decedent prior to his death.

(c) *Records.* The executor or other legal representative of the decedent, the fiduciary of a trust under a will, the life tenant and every other person to whom a uniform basis under this section is applicable, shall maintain records showing in detail all deductions, distributions, or other items for which adjustment to basis is required to be made by sections 1016 and 1017, and shall furnish to the district director such information with respect to those adjustments as he may require.

§ 1.1014–5 Gain or loss.

(a) *Sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent.* (1) The gain or loss from a sale or other disposition of a life interest, remainder interest, or other interest in property acquired from a decedent is determined by comparing the amount of the proceeds with the amount of that part of the adjusted uniform basis which is assignable to the interest sold or otherwise disposed of. The adjusted uniform basis is the uniform basis of the entire property adjusted to the time of sale or other disposition of any such interest as required by sections 1016 and 1017. The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of part II, subchapter O, chapter 1 of the Code. The proper measure of gain or loss resulting from a sale or other disposition of an interest in property acquired from a decedent is so much of the increase or decrease in the value of the entire property as is reflected in such sale or other disposition. Hence, in ascertaining the basis of a life interest, remainder interest, or other interest which is sold or otherwise disposed of, the uniform basis rule contemplates that proper adjustments will be made to reflect the change in relative value of the interests on account of the passage of time. Where a remainder interest is subject to a life interest in one person only, the factors set forth in the table which appears at the end of this subparagraph shall be used in determining the basis of the life interest or the remainder interest in the property at the time such interest is sold. The basis of the life interest or the remainder interest is computed by multiplying the uniform basis (adjusted to the time of the sale) by the appropriate factor. In the case of the sale of a life interest or a remainder interest, the factor used is the factor which appears in the life interest or the remainder interest column of the table opposite the age (at the time of the sale) of the person at whose death the life interest will terminate.

TABLE OF FACTORS

These factors are taken from Table I of Part 20 of this chapter (Estate Tax Regulations). See Table I in paragraph (f) of § 20.2031–7 of those regulations for remainder and life factors for ages not shown here.

Age of measuring life	Factor for life interest	Factor for remainder interest
21	0.78203	0.21797
22	.77576	.22424
23	.76930	.23070
24	.76266	.23734
25	.75582	.24418
26	.74880	.25120
27	.74157	.25843
28	.73416	.26584
29	.72653	.27347
30	.71871	.28129
31	.71068	.28932
32	.70245	.29755
33	.69401	.30599
34	.68536	.31464
35	.67650	.32350
36	.66743	.33257
37	.65815	.34185
38	.64867	.35133
39	.63898	.36102
40	.62908	.37092
41	.61899	.38101
42	.60869	.39131
43	.59820	.40180
44	.58751	.41249
45	.57664	.42336
46	.56559	.43441
47	.55436	.44564
48	$.54297	$.45703
49	.53141	.46859
50	.51970	.48030
51	.50785	.49215
52	.49587	.50413
53	.48377	.51623
54	.47157	.52843
55	.45926	.54074
56	.44688	.55312
57	.43442	.56558
58	.42191	.57809
59	.40936	.59064
60	.39679	.60321
61	.38422	.61578
62	.37165	.62835
63	.35911	.64089
64	.34663	.65337
65	.33420	.66580
66	.32186	.67814
67	.30962	.69038
68	.29750	.70250
69	.28552	.71448
70	.27370	.72630
71	.26205	.73795
72	.25059	.74941
73	.23934	.76066
74	.22831	.77169
75	.21752	.78248
76	.20698	.79302
77	.19670	.80330
78	.18671	.81329
79	.17700	.82300
80	.16759	.83241

In cases in which the value of an interest cannot be determined from the above table, for example, cases in which the interest to be valued is dependent upon the continuation or termination of more than one life, or there is a term-certain concurrent with one or more lives, the factor is to be computed upon the basis of the Makehamized mortality table and interest at the rate of 3½ percent a year, compounded annually. This table appears as Table 38 of United States Life Tables and Actuarial Tables 1939–1941, published by the United States Department of Commerce, Bureau of the Census. Many such factors may be found in, or readily computed with the use of the tables contained in a pamphlet entitled "Actuarial Values for Estate and Gift Tax," which may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington 25, D. C.; or a case requiring a special factor (provided the transaction is completed and not merely proposed or hypothetical) may be stated to the Commissioner who will furnish such factor. The request must be accompanied by a statement of the date of birth of each person, the duration of whose life may affect the value of the interest, and by copies of the relevant instruments.

(2) The application of this section may be illustrated by the following example:

Example. Improved realty having a fair market value of $20,000 at the date of the decedent's death on January 1, 1954, is devised to A for life, with remainder over to B. On January 1, 1958, A sells his life interest for $12,500. During each of the years 1954–57, inclusive, A was allowed a deduction of $300 for depreciation. Thus, the adjusted uniform basis of the property is $18,800 ($20,000 minus $1,200 depreciation). At the time of the sale, A was 39 years of age. The life factor to be used here is 0.63898. The portion of the uniform basis (adjusted to the time of the sale) assigned to A's life interest is $12,012.82 (0.63898×$18,800). A's gain on the sale is $487.18 ($12,500−12,012.82).

§ 1.1014–6 Special rule for adjustments to basis where property is acquired from a decedent prior to his death.

(a) *In general.* (1) The basis of property described in section 1014(b)(9) which is acquired from a decedent prior to his death shall be adjusted for depreciation, obsolescence, amortization, and depletion allowed the taxpayer on such property for the period prior to the decedent's death. Thus, in general, the adjusted basis of such property will be its fair market value at the decedent's death, or the applicable alternate valuation date, less the amount allowed (determined with regard to section 1016 (a)(2)(B)) to the taxpayer as deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion for the period held by the taxpayer prior to the decedent's death. The deduction allowed for a taxable year in which the decedent dies shall be an amount properly allocable to that part of the year prior to his death. For a discussion of the basis adjustment required by section 1014 (b)(9) where property is held in trust, see paragraph (c) of this section.

(2) Where property coming within the purview of subparagraph (1) of this paragraph was held by the decedent and his surviving spouse as tenants by the entirety or as joint tenants with right of survivorship, and joint income tax re-

turns were filed by the decedent and the surviving spouse in which the deductions referred to in subparagraph (1) were taken, there shall be allocated to the surviving spouse's interest in the property that proportion of the deductions allowed for each period for which the joint returns were filed which her income from the property bears to the total income from the property. Each spouse's income from the property shall be determined in accordance with local law.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). The taxpayer acquired income-producing property by gift on January 1, 1954. The property had a fair market value of $50,000 on the date of the donor's death, January 1, 1956, and was included in his gross estate at that amount for estate tax purposes as a transfer in contemplation of death. Depreciation in the amount of $750 per year was allowable for each of the taxable years 1954 and 1955. However, the taxpayer claimed depreciation in the amount of $500 for each of these years (resulting in a reduction in his taxes) and his income tax returns were accepted as filed. The adjusted basis of the property as of the date of the decedent's death is $49,000 ($50,000, the fair market value at the decedent's death, less $1,000, the total of the amounts actually allowed as deductions).

Example (2). On July 1, 1952, H purchased for $30,000 income-producing property which he conveyed to himself and W, his wife, as tenants by the entirety. Under local law each spouse was entitled to one-half of the income therefrom. H died on January 1, 1955, at which time the fair market value of the property was $40,000. The entire value of the property was included in H's gross estate. H and W filed joint income tax returns for the years 1952, 1953, and 1954. The total depreciation allowance for the year 1952 was $500 and for each of the other years 1953 and 1954 was $1,000. One-half of the $2,500 depreciation will be allocated to W. The adjusted basis of the property in W's hands of January 1, 1955, was $38,750 ($40,000, value on the date of H's death, less $1,250, depreciation allocated to W for periods before H's death). However, if, under local law, all of the income from the property was allocable to H, no adjustment under this paragraph would be required and W's basis for the property as of the date of H's death would be $40,000.

(b) *Multiple interests in property described in section 1014 (b) (9) and acquired from a decedent prior to his death.* (1) Where more than one person has an interest in property described in section 1014 (b) (9) which was acquired from a decedent before his death, the basis of such property and of each of the several interests therein shall, in general, be determined and adjusted in accordance with the principles contained in §§ 1.1014–4 and 1.1014–5, relating to the uniformity of basis rule. Application of these principles to the determination of basis under section 1014 (b) (9) is shown in the remaining subparagraphs of this paragraph in connection with certain commonly encountered situations involving multiple interests in property acquired from a decedent before his death.

(2) Where property is acquired from a decedent before his death, and the entire property is subsequently included in the decedent's gross estate for estate tax purposes, the uniform basis of the property, as well as the basis of each of the several interests in the property, shall be determined by taking into account the basis adjustments required by section 1014 (a) owing to such inclusion of the entire property in the decedent's gross estate. For example, suppose that the decedent transfers property in trust, with a life estate to A, and the remainder to B or his estate. The transferred property consists of 100 shares of the common stock of X Corporation, with a basis of $10,000 at the time of the transfer. At the time of the decedent's death the value of the stock is $20,000. The transfer is held to have been made in contemplation of death and the entire value of the trust is included in the decedent's gross estate. Under section 1014 (a), the uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, is $20,000. If immediately prior to the decedent's death, A's share of the uniform basis of $10,000 was $6,000, and B's share was $4,000, then, immediately after the decedent's death, A's share of the uniform basis of $20,000 is $12,000, and B's share is $8,000.

(3) (i) In cases where, due to the operation of the estate tax, only a portion of property acquired from a decedent before his death is included in the decedent's gross estate, as in cases where the decedent retained a reversion to take effect upon the expiration of a life estate in another, the uniform basis of the entire property shall be determined by taking into account any basis adjustments required by section 1014 (a) owing to such inclusion of a portion of the property in the decedent's gross estate. In such cases the uniform basis is the adjusted basis of the entire property immediately prior to the decedent's death increased (or decreased) by an amount which bears the same relation to the total appreciation (or diminution) in value of the entire property (over the adjusted basis of the entire property immediately prior to the decedent's death) as the value of the property included in the decedent's gross estate bears to the value of the entire property. For example, assume that the decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument further provides that if the decedent should survive A, the income shall be paid to the decedent for life. Assume that the decedent predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of 100 shares of the common stock of X Corporation with an adjusted basis immediately prior to the decedent's death of $10,000 (as determined under section 1015). At the time of the decedent's death, the value of the stock is $20,000, and the value of the remainder interest in the hands of B is $8,000. The uniform basis of the entire property following the decedent's death is $14,000, computed as follows:

Uniform basis prior to decedent's death	$10,000
plus	
Increase in uniform basis (determined by the following formula)	4,000
Increase in uniform basis (to be determined) / $10,000 (total appreciation) = $8,000 (value of property included in gross estate) / $20,000 (value of entire property)	
Uniform basis under section 1014 (a)	14,000

(ii) In cases of the type described in subdivision (i) of this subparagraph, the basis of any interest which is included in the decedent's gross estate may be ascertained by adding to (or subtracting from) the basis of such interest determined immediately prior to the decedent's death the increase (or decrease) in the uniform basis of the property attributable to the inclusion of the interest in the decedent's gross estate. Where the interest is sold or otherwise disposed of at any time after the decedent's death, proper adjustment must be made in order to reflect the change in value of the interest on account of the passage of time (see paragraph (a) of § 1.1014–5 and the table included therein). For an illustration of the operation of this subdivision, see step 6 of the example in § 1.1014–7.

(iii) In cases of the type described in subdivision (i) of this subparagraph (cases where, due to the operation of the estate tax, only a portion of the property is included in the decedent's gross estate), the basis for computing the depreciation, amortization, or depletion allowance shall be the uniform basis of the property determined under section 1014 (a). However, the manner of taking into account such allowance computed with respect to such uniform basis is subject to the following limitations:

(*a*) In cases where the value of the life interest is not included in the decedent's gross estate, the amount of such allowance to the life tenant under section 167 (g) (or section 611 (b)) shall not exceed (or be less than) the amount which would have been allowable to the life tenant if no portion of the basis of the property was determined under section 1014 (a). Proper adjustment shall be made for the amount allowable to the life tenant, as required by section 1016. Thus, an appropriate adjustment shall be made to the uniform basis of the property in the hands of the trustee, to the basis of the life interest in the hands of the life tenant, and to the basis of the remainder in the hands of the remainderman.

(*b*) Any remaining allowance (that is, the increase in the amount of depreciation, amortization, or depletion allowable resulting from any increase in the

uniform basis of the property under section 1014 (a)) shall not be allowed to the life tenant. The remaining allowance shall, instead, be allowed to the trustee to the extent that the trustee both (*1*) is required or permitted, by the governing trust instrument (or under local law), to maintain a reserve for depreciation, amortization, or depletion, and (*2*) actually maintains such a reserve. If, in accordance with the preceding sentence, the trustee does maintain such a reserve, the remaining allowance shall be taken into account, under section 1016, in adjusting the uniform basis of the property in the hands of the trustee and in adjusting the basis of the remainder interest in the hands of the remainderman, but shall not be taken into account, under section 1016, in determining the basis of the life interest in the hands of the life tenant. For an example of the operation of this subdivision, see paragraph (b) of § 1.1014–7.

(4) In cases where the basis of any interest in property is not determined under section 1014 (a), as where such interest (i) is not included in the decedent's gross estate, or (ii) is sold, exchanged or otherwise disposed of before the decedent's death, the basis of such interest shall be determined under other applicable provisions of the Code. To illustrate, in the example shown in subparagraph (3) (i) of this paragraph the basis of the life estate in the hands of A shall be determined under section 1015, relating to the basis of property acquired by gift. If, on the other hand, A had sold his life interest prior to the decedent's death, the basis of the life estate in the hands of A's transferee would be determined under section 1012.

(c) *Adjustments for deductions allowed prior to the decedent's death.* (1) As stated in paragraph (a) of this section, section 1014(b)(9) requires a reduction in the uniform basis of property acquired from a decedent before his death for certain deductions allowed in respect of such property during the decedent's lifetime. In general, the amount of the reduction in basis required by section 1014(b)(9) shall be the aggregate of the deductions allowed in respect of the property, but shall not include deductions allowed in respect of the property to the decedent himself. In cases where, owing to the operation of the estate tax, only a part of the value of the entire property is included in the decedent's gross estate, the amount of the reduction required by section 1014 (b) (9) shall be an amount which bears the same relation to the total of all deductions (described in paragraph (a) of this section) allowed in respect of the property as the value of the property included in the decedent's gross estate bears to the value of the entire property.

(2) The application of this paragraph may be illustrated by the following examples:

Example (*1*). The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The property transferred in trust consists of an apartment building with a basis of $50,000 at the time of the transfer. The decedent dies 2 years after the transfer is made and the gift is held to have been made in contemplation of death. Depreciation on the property was allowed in the amount of $1,000 annually. At the time of the decedent's death the value of the property is $58,000. The uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, immediately after the decedent's death is $56,000 ($58,000, fair market value of the property immediately after the decedent's death, reduced by $2,000, deductions for depreciation allowed prior to the decedent's death).

Example (*2*). The decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent predeceases A and the present value of the remainder interest is included in the decedent's gross estate for estate tax purposes. The property transferred consists of an apartment building with a basis of $110,000 at the time of the transfer. Following the creation of the trust and during the balance of the decedent's life, deductions for depreciation were allowed on the property in the amount of $10,000. At the time of decedent's death the value of the entire property is $150,000, and the value of the remainder interest is $100,000. Accordingly, the uniform basis of the property in the hands of the trustee, the life tenant, and the remainderman, as adjusted under section 1014 (b) (9), is $126,666, computed as follows:

Uniform basis prior to decedent's death	$100,000
plus	
Increase in uniform basis—before reduction (determined by the following formula)	33,333
Increase in uniform basis (to be determined) / $50,000 (total appreciation of property since time of transfer) = $100,000 (value of property included in gross estate) / $150,000 (value of entire property)	
less	133,333
Deductions allowed prior to decedent's death—taken into account under section 1014 (b) (9) (determined by the following formula)	6,667
Prior deductions taken into account (to be determined) / $10,000 (total deductions allowed prior to decedent's death) = $100,000 (value of property included in gross estate) / $150,000 (value of entire property)	
Uniform basis under section 1014	126,666

§ 1.1014–7 Example applying rules of §§ 1.1014–4 through 1.1014–6 to case involving multiple interests.

(a) On January 1, 1950, the decedent creates a trust to pay the income to A for life, remainder to B or his estate. The trust instrument provides that if the decedent should survive A, the income shall be paid to the decedent for life. The decedent, who died on January 1, 1955, predeceases A, so that, due to the operation of the estate tax, only the present value of the remainder interest is included in the decedent's gross estate. The trust consists of an apartment building with a basis of $30,000 at the time of transfer. Under the trust instrument the trustee is required to maintain a reserve for depreciation. During the decedent's lifetime depreciation is allowed in the amount of $800 annually. At the time of the decedent's death the value of the apartment building is $45,000. A, the life tenant, is 43 years of age at the time of the decedent's death. Immediately after the decedent's death, the uniform basis of the entire property under section 1014 (a) is $32,027; A's basis for the life interest is $15,553; and B's basis for the remainder interest is $16,474, computed as follows:

Step 1. Uniform basis (adjusted) immediately prior to decedent's death:	
Basis at time of transfer	$30,000
less	
Depreciation allowed under section 1016 before decedent's death ($800×5)	4,000
	26,000
Step 2. Value of property included in decedent's gross estate:	
0.40180 (remainder factor, age 43) × $45,000 (value of entire property)	$18,081
Step 3. Uniform basis of property under section 1014 (a), before reduction required by section 1014 (b) (9):	
Uniform basis (adjusted) prior to decedent's death	$26,000
Increase in uniform basis (determined by the following formula)	7,634
Increase in uniform basis (to be determined) / $19,000 (total appreciation, $45,000—$26,000) = $18,081 (value of property included in gross estate) / $45,000 (value of entire property)	
	33,634

Step 4. Uniform basis reduced as required by section 1014 (b) (9) for deductions allowed prior to death:

Uniform basis before reduction	$33,634
less	
Deductions allowed prior to decedent's death—taken into account under section 1014 (b) (9) (determined by the following formula)	1,607
Prior deductions taken into account (to be determined) / $4,000 (total deductions allowed prior to decedent's death) = $18,081 (value of property included in gross estate) / $45,000 (value of entire property)	
	32,027

Step 5. A's basis for the life interest at the time of the decedent's death, determined under section 1015:

0.59820 (life factor, age 43) × $26,000	$15,553

Step 6. B's basis for the remainder interest, determined under section 1014 (a):

Basis prior to the decedent's death:		
0.40180 (remainder factor, age 43) × $26,000		$10,447
plus		
Increase in uniform basis owing to decedent's death:		
Increase in uniform basis	$7,634	
Reduction required by section 1014 (b) (9)	1,607	
		6,027
		16,474

(b) Assume the same facts as in paragraph (a) of this section. Assume further, that following the decedents' death depreciation is allowed in the amount of $1,000 annually. As of January 1, 1964, when A's age is 52, the adjusted uniform basis of the entire property is $23,027; A's basis for the life interest is $9,323; and B's basis for the remainder interest is $13,704, computed as follows:

Step 7. Uniform basis (adjusted) as of January 1, 1964:

Uniform basis determined under section 1014 (a), reduced as required by section 1014 (b) (9)	$32,027
less	
Depreciation allowed since decedent's death ($1,000 × 9)	9,000
	23,027

Step 8. Allocable share of adjustment for depreciation allowable in the nine years since the decedent's death:

A's interest

0.49587 (life factor, age 52) × $7,200 ($800, depreciation attributable to uniform basis before increase under section 1014 (a), × 9)	$3,570

B's interest

0.50413 (remainder factor, age 52) × $7,200 ($800, depreciation attributable to uniform basis before increase under section 1014(a), × 9)	$3,630
plus	
$200 (annual depreciation attributable to increase in uniform basis under section 1014 (a)) × 9	1,800
	5,430

Step 9. Tentative bases of A's and B's interests as of January 1, 1964 (before adjustment for depreciation).

A's interest

0.49587 (life factor, age 52) × $26,000 (adjusted uniform basis immediately before decedent's death)	$12,893

B's interest

0.50413 (remainder factor, age 52) × $26,000 (adjusted uniform basis immediately before decedent's death)	$13,107
plus	
Increase in uniform basis owing to inclusion of remainder in decedent's gross estate	6,027
	19,134

Step 10. Bases of A's and B's interests as of January 1, 1964:

A	
Tentative basis (Step 9)	$12,893
less	
Allocable depreciation (Step 8)	3,570
	9,323
B	
Tentative basis (Step 9)	$19,134
less	
Allocable depreciation (Step 8)	5,430
	13,704

§ 1.1014–8 Bequest, devise, or inheritance of a remainder interest.

(a) (1) Where property is transferred for life, with remainder in fee, and the remainderman dies before the life tenant, no adjustment is made to the uniform basis of the property on the death of the remainderman (see paragraph (a) of § 1.1014–4). However, the basis of the remainderman's heir, legatee, or devisee for the remainder interest is determined by adding to (or subtracting from) the part of the adjusted uniform basis assigned to the remainder interest (determined in accordance with the principles set forth in §§ 1.1014–4 through 1.1014–6) the difference between—

(i) The value of the remainder interest included in the remainderman's estate, and

(ii) The basis of the remainder interest immediately prior to the remainderman's death.

(2) The basis of any property distributed to the heir, legatee, or devisee upon termination of a trust (or legal life estate) or at any other time (unless included in the gross income of the legatee or devisee) shall be determined by adding to (or subtracting from) the adjusted uniform basis of the property thus distributed the difference between—

(i) The value of the remainder interest in the property included in the remainderman's estate, and

(ii) The basis of the remainder interest in the property immediately prior to the remainderman's death.

(b) The provisions of paragraph (a) of this section are illustrated by the following examples:

Example (1). Assume that, under the will of a decedent, property consisting of common stock with a value of $1,000 at the time of the decedent's death is transferred in trust, to pay the income to A for life, remainder to B or to B's estate. B predeceases A and bequeaths the remainder interest to C. Assume that B dies on January 1, 1956, and that the value of the stock originally transferred is $1,600 at B's death. A's age at that time is 37. The value of the remainder interest included in B's estate is $547 (0.34185, remainder factor age 37, × $1,600), and hence $547 is C's basis for the remainder interest immediately after B's death. Assume that C sells the remainder interest on January 1, 1961, when A's age is 42. C's basis for the remainder interest at the time of such sale is $596, computed as follows:

Basis of remainder interest computed with respect to uniform basis of entire property (0.39131, remainder factor age 42, × $1,000, uniform basis of entire property)		$391
plus		
Value of remainder interest included in B's estate	$547	
less		
Basis of remainder interest immediately prior to B's death (0.34185, remainder factor age 37, × $1,000)	342	
		205
Basis of C's remainder interest at the time of sale		596

Example (2). Assume the same facts as in example (1), except that C does not sell the remainder interest. Upon A's death terminating the trust, C's basis for the stock distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust		$1,000
plus		
Value of remainder interests in the property at the time of B's death	$547	
less		
B's share of uniform basis of the property at the time of his death	342	
		205
C's basis for the stock distributed to him upon the termination of the trust		1,205

Example (3). Assume the same facts as in example (2), except that the property transferred is depreciable. Assume further that $100 of depreciation was allowed prior to B's death and that $50 of depreciation is allowed between the time of B's death and the termination of the trust. Upon A's death terminating the trust, C's basis for the property distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust:		
Uniform basis immediately after decedent's death	$1,000	
Depreciation allowed following decedent's death	150	
		$850
plus		
Value of remainder interest in the property at the time of B's death	547	
less		
B's share of uniform basis of the property at the time of his death (0.34185×$900, uniform basis at B's death)	308	
		239
C's basis for the property distributed to him upon the termination of the trust		1,089

(c) The rules stated in paragraph (a) of this section do not apply where the basis of the remainder interest in the hands of the remainderman's transferee is determined by reference to its cost to such transferee. See also paragraph (a) of § 1.1014–4. Thus, if, in example (*1*) of paragraph (b) of this section B sold his remainder interest to C for $547 in cash, C's basis for the stock distributed to him upon the death of A terminating the trust is $547.

§ 1.1015 Statutory provisions; basis of property acquired by gifts and transfers in trust.

SEC. 1015. *Basis of property acquired by gifts and transfers in trust*—(a) *Gifts after December 31, 1920.* If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary or his delegate shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary or his delegate finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary or his delegate as of the date or approximate date at which, according to the best information that the Secretary or his delegate is able to obtain, such property was acquired by such donor or last preceding owner.

(b) *Transfer in trust after December 31, 1920.* If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer under the law applicable to the year in which the transfer was made.

(c) *Gift or transfer in trust before January 1, 1921.* If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

§ 1.1015–1 Basis of property acquired by gift after December 31, 1920.

(a) *General rule.* (1) In the case of property acquired by gift after December 31, 1920 (whether by a transfer in trust or otherwise), the basis of the property for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. The same rule applies in determining loss unless the basis (adjusted for the period prior to the date of gift in accordance with sections 1016 and 1017) is greater than the fair market value of the property at the time of the gift. In such case, the basis for determining loss is the fair market value at the time of the gift.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example.

Example. A acquires by gift income-producing property which has an adjusted basis of $100,000 at the date of gift. The fair market value of the property at the date of gift is $90,000. A later sells the property for $95,000. In such case there is neither gain nor loss. The basis for determining loss is $90,000; therefore, there is no loss. Furthermore, there is no gain, since the basis for determining gain is $100,000.

(b) *Uniform basis; proportionate parts of.* Property acquired by gift has a single or uniform basis although more than one person may acquire an interest in such property. The uniform basis of the property remains fixed subject to proper adjustment for items under sections 1016 and 1017. However, the value of the proportionate parts of the uniform basis represented, for instance, by the respective interests of the life tenant and remainderman are adjustable to reflect the change in the relative values of such interest on account of the lapse of time. The portion of the basis attributable to an interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014–5.

(c) *Time of acquisition.* The date that the donee acquires an interest in property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee. Thus, the date that the donee acquires an interest in property by gift where he is a successor in interest, such as in the case of a remainderman of a life estate or a beneficiary of the distribution of the corpus of a trust, is the date such interests are created by the donor and not the date the property is actually acquired.

(d) *Property acquired by gift from a decedent dying after December 31, 1953.* If an interest in property was acquired by the taxpayer by gift from a donor dying after December 31, 1953, under conditions which require the inclusion of the property in the donor's gross estate for estate tax purposes, and the property had not been sold, exchanged, or otherwise disposed of by the taxpayer before the donor's death, see the rules prescribed in section 1014 and the regulations thereunder.

(e) *Fair market value.* For the purposes of this section, the value of property as appraised for the purpose of the Federal gift tax, or, if the gift is not subject to such tax, its value as appraised for the purpose of a State gift tax, shall be deemed to be the fair market value of the property at the time of the gift.

(f) *Reinvestments by fiduciary.* If the property is an investment by the fiduciary under the terms of the gift (as, for example, in the case of a sale by the fiduciary of property transferred under the terms of the gift, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

(g) *Records.* To insure a fair and adequate determination of the proper basis under section 1015, persons making or receiving gifts of property should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value as of March 1, 1913, or its fair market value as of the date of the gift.

§ 1.1015–2 Transfer of property in trust after December 31, 1920.

(a) *General rule.* (1) In the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.

(2) The principles stated in paragraph (b) of § 1.1015–1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust after December 31, 1920.

(b) *Reinvestment by fiduciary.* If the property is an investment made by the fiduciary (as, for example, in the case of a sale by the fiduciary of property transferred by the grantor, and the reinvestment of the proceeds), the cost or other basis to the fiduciary is taken in lieu of the basis specified in paragraph (a) of this section.

§ 1.1015–3 Gift or transfer in trust before January 1, 1921.

(a) In the case of property acquired by gift or transfer in trust before January 1, 1921, the basis of such property is the fair market value thereof at the time of the gift or at the time of the transfer in trust.

(b) The principles stated in paragraph (b) of § 1.1015–1 concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by gift or transfer in trust before January 1, 1921. In addition, if an interest in such property was acquired from a decedent and the property had not been sold, exchanged, or otherwise disposed of before the death of the donor, the rules prescribed in section 1014 and the regulations thereunder are applicable in determining the basis of such property in the hands of the taxpayer.

§ 1.1015–4 Transfers in part a gift and in part a sale.

(a) *General rule.* Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of (1) the amount paid by the transferee for the property, and (2) any excess of the transferor's adjusted basis over such amount. Thus, the unadjusted basis of the property in the hands of the transferee is the greater of (1) the amount paid for the property, or (2) the transferor's adjusted basis at the time of the transfer. For determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor, see paragraph (e) of § 1.1001–1.

(b) *Examples.* The rule of paragraph (a) of this section is illustrated by the following examples:

Example (1). If A transfers property to his son for $30,000, and such property at the time of the transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $30,000.

Example (2). If A transfers property to his son for $60,000, and such property at the time of transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (3). If A transfers property to his son for $30,000, and such property at the time of transfer has an adjusted basis in A's hands of $60,000 (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (4). If A transfers property to his son for $30,000 and such property at the time of transfer has an adjusted basis of $90,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property by the son its unadjusted basis in his hands is $60,000.

§ 1.1016 Statutory provisions; adjustments to basis.

SEC. 1016. *Adjustments to basis*—(a) *General rule.* Proper adjustment in respect of the property shall in all cases be made—

(1) For expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) For taxes or other carrying charges described in section 266, or

(B) For expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) In respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) Allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) Resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under section 167 (b) (1). Subparagraph (B) of this paragraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under section 1020. Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(3) In respect of any period—

(A) Before March 1, 1913, and

(B) Since February 28, 1913, during which such property was held by a person or an organization not subject to income taxation under this chapter or prior income tax laws,

for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(4) In the case of stock (to the extent not provided for in the foregoing paragraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057), or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921);

(5) In the case of any bond (as defined in section 171 (d)) the interest on which is wholly exempt from the tax imposed by this subtitle, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 171 (a) (2), and in the case of any other bond (as defined in section 171 (d)) to the extent of the deductions allowable pursuant to section 171 (a) (1) with respect thereto;

(6) In the case of any short-term municipal bond (as defined in section 75 (b)), to the extent provided in section 75 (a) (2);

(7) In the case of a residence the acquisition of which resulted, under section 1034, in the nonrecognition of any part of the gain realized on the sale, exchange, or involuntary conversion of another residence, to the extent provided in section 1034 (e);

(8) In the case of property pledged to the Commodity Credit Corporation, to the extent of the amount received as a loan from the Commodity Credit Corporation and treated by the taxpayer as income for the year in which received pursuant to section 77, and to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability;

(9) For amounts allowed as deductions as deferred expenses under section 616 (b) (relating to certain expenditures in the development of mines) and resulting in a reduction of the taxpayer's taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(10) For amounts allowed as deductions as deferred expenses under section 615 (b) (relating to certain exploration expenditures) and resulting in a reduction of the taxpayer's taxes under this subtitle but not less than the amounts allowable under such section for the taxable year and prior years;

(11) For deductions to the extent disallowed under section 268 (relating to sale of land with unharvested crops), notwithstanding the provisions of any other paragraph of this subsection;

(12) To the extent provided in section 28 (h) of the Internal Revenue Code of 1939 in the case of amounts specified in a shareholder's consent made under section 28 of such code;

(13) To the extent provided in section 551 (f) in the case of the stock of United States shareholders in a foreign personal holding company;

(14) For amounts allowed as deductions as deferred expenses under section 174 (b) (1) (relating to research and experimental expenditures) and resulting in a reduction of the taxpayers' taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(15) For deductions to the extent disallowed under section 272 (relating to disposal of coal), notwithstanding the provisions of any other paragraph of this subsection;

(16) For amounts allowed as deductions for expenditures treated as deferred expenses under section 177 (relating to trademark and trade name expenditures) and resulting in a reduction of the taxpayer's taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years.

(b) *Substituted basis.* Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, then the adjustments provided in subsection (a) shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. A similar rule shall be applied in the case of a series of substituted bases. The term "substituted basis" as used in this section means a basis determined under any provision of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses), or under any corresponding provision of a prior income tax law, providing that the basis shall be determined—

(1) By reference to the basis in the hands of a transferor, donor, or grantor, or

(2) By reference to other property held at any time by the person for whom the basis is to be determined.

(c) *Separate mineral interests treated as one property.* For treatment of separate mineral interests as one property, see section 614.

[Sec. 1016 as amended by sec. 4(c), Act of June 29, 1956 (Pub. Law 629, 84th Cong., 70 Stat. 407)]

§ 1.1016–1 Adjustments to basis; scope of section.

Section 1016 and §§ 1.1016–2 to 1.1016–10, inclusive, contain the rules relating to the adjustments to be made to the basis of property to determine the adjusted basis as defined in section 1011.

However, if the property was acquired from a decedent before his death, see § 1.1014–6 for adjustments on account of certain deductions allowed the taxpayer for the period between the date of acquisition of the property and the date of death of the decedent. If an election has been made under the Retirement-Straight Line Adjustment Act of 1958 (26 U.S.C. 1016 note), see § 1.9001–1 for special rules for determining adjusted basis in the case of a taxpayer who has changed from the retirement to the straight-line method of computing depreciation allowances.

§ 1.1016–2 Items properly chargeable to capital account.

(a) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income. See the regulations under section 263 (c).

(b) The application of the foregoing provisions may be illustrated by the following example:

Example. A, who makes his returns on the calendar year basis, purchased property in 1941 for $10,000. He subsequently expended $6,000 for improvements. Disregarding, for the purpose of this example, the adjustments required for depreciation, the adjusted basis of the property is $16,000. If A sells the property in 1954 for $20,000, the amount of his gain will be $4,000.

(c) Adjustments to basis shall be made for carrying charges such as taxes and interest, with respect to property (whether real or personal, improved or unimproved, and whether productive or unproductive), which the taxpayer elects to treat as chargeable to capital account under section 266, rather than as an allowable deduction. The term "taxes" for this purpose includes duties and excise taxes but does not include income taxes.

(d) Expenditures described in section 173 to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical are chargeable to capital account only in accordance with and in the manner provided in the regulations under section 173.

§ 1.1016–3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

(a) *In general*—(1) *Adjustment where deduction is claimed.* (i) For taxable periods beginning on or after January 1, 1952, the cost or other basis of property shall be decreased for exhaustion, wear and tear, obsolescence, amortization, and depletion by the greater of the following two amounts: (*a*) the amount allowed as deductions in computing taxable income, to the extent resulting in a reduction of the taxpayer's income taxes, or (*b*) the amount allowable for the years involved. See paragraph (b) of this section. Where the taxpayer makes an appropriate election the above rule is applicable for periods since February 28, 1913, and before January 1, 1952. See paragraph (d) of this section. For rule for such periods where no election is made, see paragraph (c) of this section.

(ii) The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion shall be made on the basis of facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any such allowance or his taking an allowance plainly inadequate under the known facts in prior years. In the case of depreciation, if in prior years the taxpayer has consistently taken proper deductions under one method, the amount allowable for such prior years shall not be increased even though a greater amount would have been allowable under another proper method. For rules governing losses on retirement of depreciable property, including rules for determining basis, see § 1.167(a)–8. This subdivision may be illustrated by the following example:

Example. An asset was purchased January 1, 1950, at a cost of $10,000. The useful life of the asset is 10 years. It has no salvage value. Depreciation was deducted and allowed for 1950 to 1954 as follows:

1950	$500
1951	-----
1952	1,000
1953	1,000
1954	1,000
Total amount allowed	3,500

The correct reserve as of December 31, 1954, is computed as follows:

Dec. 31:	
1950 ($10,000÷10)	$1,000
1951 ($9,000÷9)	1,000
1952 ($8,000÷8)	1,000
1953 ($7,000÷7)	1,000
1954 ($6,000÷6)	1.000
Reserve Dec. 31, 1954	5,000

Depreciation for 1955 is computed as follows:

Cost	$10,000
Reserve as of December 31, 1954	5,000
Unrecovered cost	5,000
Depreciation allowable for 1955 ($5,000÷5)	1,000

(2) *Adjustment for amount allowable where no depreciation deduction claimed.* (i) If the taxpayer has not taken a depreciation deduction either in the taxable year or for any prior taxable year, adjustments to basis of the property for depreciation allowable shall be determined by using the straight-line method of depreciation. (See § 1.1016–4 for adjustments in the case of persons exempt from income taxation.)

(ii) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, if the taxpayer with respect to any property has taken a deduction for depreciation properly under one of the methods provided in section 167 (b) for one or more years but has omitted the deduction in other years, the adjustment to basis for the depreciation allowable in such a case will be the deduction under the method which was used by the taxpayer with respect to that property. Thus, if A acquired property in 1954 on which he properly computed his depreciation deduction under the method described in section 167 (b) (2) (the declining-balance method) for the first year of its useful life but did not take a deduction in the second and third year of the asset's life, the adjustment to basis for depreciation allowable for the second and third year will be likewise computed under the declining-balance method.

(3) *Adjustment for depletion deductions with respect to taxable years before 1932.* Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall not exceed a depletion deduction which would have been allowable for such year if computed without reference to discovery value or a percentage of income.

(b) *Adjustment for periods beginning on or after January 1, 1952.* The decrease required by paragraph (a) of this section for deductions in respect of any period beginning on or after January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing taxable income under subtitle A of the Code or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income) or prior income, war-profits, or excess-profits tax laws; or

(2) The amount properly allowable as deductions in computing taxable income under subtitle A of the Code or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(c) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where no election made.* If no election has been properly made under section 1020, or under section 113 (d) of the Internal Revenue Code of 1939 (see paragraph (d) of this section), the decrease required by paragraph (a) of this section for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever of the following amounts is the greater:

(1) The amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws;

(2) The amount properly allowable in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws.

For the purpose of determining the decrease required by this paragraph, it is immaterial whether or not the amount under subparagraph (1) of this paragraph or the amount under subparagraph (2) of this paragraph would have resulted in a reduction for any taxable year of the taxpayer's taxes.

(d) *Adjustment for periods since February 28, 1913, and before January 1, 1952, where election made.* If an election has been properly made under section 1020, or under section 113 (d) of the Internal Revenue Code of 1939, the decrease required by paragraph (a) of this section for deductions in respect of any period since February 28, 1913, and before January 1, 1952, shall be whichever is the greater of the following amounts:

(1) The amount allowed as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws and resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under such chapter 1 (other than subchapter E, relating to tax on self-employment income), subchapter E, chapter 2, of the Internal Revenue Code of 1939, or prior income, war-profits, or excess-profits tax laws;

(2) The amount properly allowable as deductions in computing net income under chapter 1 of the Internal Revenue Code of 1939 or prior income tax laws (whether or not the amount properly allowable would have caused a reduction for any taxable year of the taxpayer's taxes).

(e) *Determination of amount allowed which reduced taxpayer's taxes.* (1) As indicated in paragraphs (b) and (d) of this section, there are situations in which it is necessary to determine (for the purpose of ascertaining the basis adjustment required by paragraph (a) of this section) the extent to which the amount allowed as deductions resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws. This amount (amount allowed which resulted in a reduction of the taxpayer's taxes) is hereinafter referred to as the "tax-benefit amount allowed." For the purpose of determining whether the tax-benefit amount allowed exceeded the amount allowable, a determination must be made of that portion of the excess of the amount allowed over the amount allowable which, if disallowed, would not have resulted in an increase in any such tax previously determined. If the entire excess of the amount allowed over the amount allowable could be disallowed without any such increase in tax, the tax-benefit amount allowed shall not be considered to have exceeded the amount allowable. In such a case (if paragraph (b) or (d) of this section is applicable) the reduction in basis required by paragraph (a) of this section would be the amount properly allowable as a deduction. If only part of such excess could be disallowed without any such increase in tax, the tax-benefit amount allowed shall be considered to exceed the amount allowable to the extent of the remainder of such excess. In such a case (if paragraph (b) or (d) of this section is applicable), the reduction in basis required by paragraph (a) of this section would be the amount of the tax-benefit amount allowed.

(2) For the purpose of determining the tax-benefit amount allowed the tax previously determined shall be determined under the principles of section 1314. The only adjustments made in determining whether there would be an increase in tax shall be those resulting from the disallowance of the amount allowed. The taxable years for which the determination is made shall be the taxable year for which the deduction was allowed and any other taxable year which would be affected by the disallowance of such deduction. Examples of such other taxable years are taxable years to which there was a carryover or carryback of a net operating loss from the taxable year for which the deduction was allowed, and taxable years for which a computation under section 111 or section 1333 was made by reference to the taxable year for which the deduction was allowed. In determining whether the disallowance of any part of the deduction would not have resulted in an increase in any tax previously determined, proper adjustment must be made for previous determinations under section 1311, or section 3801 of the Internal Revenue Code of 1939, and for any previous application of section 1016 (a) (2) (B), or section 113 (b) (1) (B) (ii) of the Internal Revenue Code of 1939.

(3) If a determination under section 1016 (a) (2) (B) must be made with respect to several properties for each of which the amount allowed for the taxable year exceeded the amount allowable, the tax-benefit amount allowed with respect to each of such properties shall be an allocated portion of the tax-benefit amount allowed determined by reference to the sum of the amounts allowed and the sum of the amounts allowable with respect to such several properties.

(4) In the case of property held by a partnership or trust, the computation of the tax-benefit amount allowed shall take into account the tax benefit of the partners or beneficiaries, as the case may be, from the deduction by the partnership or trust of the amount allowed to the partnership or the trust. For this purpose, the determination of the amount allowed which resulted in a tax benefit to the partners or beneficiaries shall be made in the same manner as that provided above with respect to the taxes of the person holding the property.

(5) A taxpayer seeking to limit the adjustment to basis to the tax-benefit amount allowed for any period, in lieu of the amount allowed, must establish the tax-benefit amount allowed. A failure of adequate proof as to the tax-benefit amount allowed with respect to one period does not preclude the taxpayer from limiting the adjustment to basis to the tax-benefit amount allowed with respect to another period for which adequate proof is available. For example, a corporate transferee may have available adequate records with respect to the tax effect of the deduction of erroneous depreciation for certain taxable years, but may not have available adequate records with respect to the deduction of excessive depreciation for other taxable years during which the property was held by its transferor. In such case the corporate transferee shall not be denied the right to apply this section with respect to the erroneous depreciation for the period for which adequate proof is available.

(f) *Determination of amount allowable in prior taxable years.* (1) One of the factors in determining the adjustment to basis as of any date is the amount of depreciation, depletion, etc., allowable for periods prior to such date. The amount allowable for such prior periods is determined under the law applicable to such prior periods; all adjustments required by the law applicable to such periods are made in determining the adjusted basis of the property for the purpose of determining the amount allowable. Provisions corresponding to the rules in section 1016 (a) (2) (B) described in paragraphs (d) and (e) of this section, which limit adjustments to the "tax-benefit amount allowed" where an election is properly exercised, were first enacted by the Act of July 14, 1952 (66 Stat. 629). That law provided that corresponding rules are deemed to be includible in all revenue laws applicable to taxable years ending after December 31, 1931. Accordingly, those rules shall be taken into account in determining the amount of depreciation, etc., allowable for any taxable year ending after December 31, 1931. For example, if the adjusted basis of property held by the taxpayer since January 1, 1930, is determined as of January 1, 1955, and if an election was properly made under section 1020, or section 113 (d) of the Internal Revenue Code of 1939, then the amount allowable which is taken into account in computing the adjusted basis as of January 1, 1955, shall be determined by taking those rules into account for all taxable years ending after December 31, 1931. The Act of July 14, 1952, made no change in the law applicable in determining the amount allowable for taxable years ending before January 1, 1932. If there was a final decision of a court prior to the enactment of the Act of July 14, 1952, determining the amount allowable for a particular taxable year, such determination shall be adjusted. In such case the adjustment shall be made only for the purpose of taking the provision of that law into account and only to the extent made necessary by such provisions.

(2) Although the Act of July 14, 1952, amended the law applicable to all taxable years ending after December 31, 1931, the amendment does not permit refund, credit, or assessment of a deficiency for any taxable year for which such refund, credit, or assessment was barred by any law or rule of law.

(g) *Property with transferred basis.* The following rules apply in the determination of the adjustments to basis of property in the hands of a transferee, donee, or grantee which are required by section 1016 (b), or section 113 (b) (2) of the Internal Revenue Code of 1939, with respect to the period the property was held by the transferor, donor, or grantor:

(1) An election or a revocation of an election under section 1020, or section

113 (d) of the Internal Revenue Code of 1939, by a transferor, donor, or grantor, which is made after the date of the transfer, gift, or grant of the property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. An election or a revocation of an election made before the date of the transfer, gift, or grant of the property shall be taken into account in determining under section 1016 (b) the adjustments to basis of such property as of the date of the transfer, gift, or grant, whether or not an election or a revocation of an election under section 1020, or section 113 (d) of the Internal Revenue Code of 1939, was made by the transferee, donee, or grantee.

(2) An election by the transferee, donee, or grantee, or a revocation of such an election shall be applicable in determining the adjustments to basis for the period during which the property was held by the transferor, donor, or grantor, whether or not the transferor, donor, or grantor had made an election or a revocation of an election, provided that the property was held by the transferee, donee, or grantee at any time on or before the date on which the election or revocation was made.

(h) *Examples.* The application of section 1016 (a) (1) and (2) may be illustrated by the following examples:

Example (1). The case of Corporation A discloses the following facts:

(1) Year	(2) Amount allowed	(3) Amount allowed which reduced taxpayer's taxes	(4) Amount allowable	(5) Amount allowable but not less than amount allowed	(6) Amount allowable but not less than amount allowed which reduced taxpayer's taxes
1949	$6,000	$5,500	$5,000	$6,000	$5,500
1950	7,000	7,000	6,500	7,000	7,000
1951	5,000	4,000	6,500	6,500	6,500
Total, 1949–51				19,500	19,000
1952	6,500	6,500	6,000		6,500
1953	5,000	4,000	4,000		4,000
1954	4,500	4,500	6,000		6,000
Total, 1952–54					16,500

The cost or other basis is to be adjusted by $16,500 with respect to the years 1952–54, that is, by the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes. An adjustment must also be made with respect to the years 1949–1951, the amount of such adjustment depending upon whether an election was properly made under section 1020, or section 113 (d) of the Internal Revenue Code of 1939. If no such election was made, the amount of the adjustment with respect to the years 1949–51 is $19,500, that is, the amount allowed but not less than the amount allowable. If an election was properly made, the amount of the adjustment with respect to the years 1949–51 is $19,000, that is, the amount allowable but not less than the amount allowed which reduced the taxpayer's taxes.

Example (2). Corporation A, which files its returns on the basis of a calendar year, purchased a building on January 1, 1950, at a cost of $100,000. On the basis of the facts reasonably known to exist at the end of 1950, a period of 50 years should have been used as the correct useful life of the building; nevertheless, depreciation was computed by Corporation A on the basis of a useful life of 25 years, and was allowed for 1950 through 1953 as a deduction in an annual amount of $4,000. The building was sold on January 1, 1954. Corporation A did not make an election under section 1020, or section 113 (d) of the Internal Revenue Code of 1939. No part of the amount allowed Corporation A for any of the years 1950 through 1953 resulted in a reduction of Corporation A's taxes. The adjusted basis of the building as of January 1, 1954, is $88,166, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on Jan. 1	Remaining life on Jan. 1	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$4,000	98,000	49	1,959	4,000
1952	8,000	92,000	48	1,917	4,000
1953	9,017	90,083	47	1,917	4,000
1954	11,834	88,166			

Example (3). The facts are the same as in example (2), except that Corporation A made a proper election under section 1020. In such case, the adjusted basis of the building as of January 1, 1954, is $92,000 computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on Jan. 1	Remaining life on Jan. 1	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$2,000	98,000	49	2,000	4,000
1952	4,000	96,000	48	2,000	4,000
1953	6,000	94,000	47	2,000	4,000
1954	8,000	92,000			

Example (4). If it is assumed that in example (2), or in example (3), all of the deduction allowed Corporation A for 1953 had resulted in a reduction of A's taxes, the adjustment to the basis of the building for depreciation for 1953 would reflect the entire $4,000 deduction. In such case, the adjusted basis of the building as of January 1, 1954, would be $86,083 in example (2), and $90,000 in example (3).

Example (5). The facts are the same as in example (2), except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation for that year resulted in a reduction of A's taxes. In such case, the adjustments to the basis of the building remain the same as those set forth in example (2).

Example (6). The facts are the same as in example (3), except that for the year 1950 all of the $4,000 amount allowed Corporation A as a deduction for depreciation resulted in a reduction of A's taxes. In such case, the adjusted basis of the building as of January 1, 1954, is $90,123, computed as follows:

Taxable year	Adjustments to basis as of beginning of taxable year	Adjusted basis on Jan. 1	Remaining life on Jan. 1	Depreciation allowable	Depreciation allowed
1950		$100,000	50	$2,000	$4,000
1951	$4,000	96,000	49	1,959	4,000
1952	5,959	94,041	48	1,959	4,000
1953	7,918	92,082	47	1,959	4,000
1954	9,877	90,123			

§ 1.1016–4 Exhaustion, wear and tear, obsolescence, amortization, and depletion; periods during which income was not subject to tax.

Adjustments to basis must be made for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent actually sustained in respect of:

(a) Any period before March 1, 1913, and

(b) Any period since February 28, 1913, during which the property was held by a person or an organization not subject to income taxation under chapter 1 of the Code or prior income tax laws.

The amount of the aforedescribed deductions actually sustained is that amount charged off on the books of the taxpayer where such amount is considered by the Commissioner to be reasonable. Otherwise the amount actually sustained will be the amount that would have been allowable as a deduction had the taxpayer been subject to income tax during such period. In the case of depreciation, such deduction will be determined by using the straight line method.

§ 1.1016–5 Miscellaneous adjustments to basis.

(a) *Certain stock distributions.* (1) In the case of stock, the cost or other basis must be diminished by the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057) or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or the Revenue Act of 1921). For adjustments to basis in the case of certain corporate distributions, see section 301 and the regulations thereunder.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. A, who makes his returns upon the calendar year basis, purchased stock in 1923 for $5,000. He received in 1924 a distribution of $2,000 paid out of earnings and profits of the corporation accumulated before March 1, 1913. The adjusted basis for determining the gain or loss from the sale or other disposition of the stock in 1954 is $5,000 less $2,000, or $3,000, and the amount of the gain or loss from the sale or other disposition of the stock is the difference between $3,000 and the amount realized from the sale or other disposition.

(b) *Amortizable bond premium.* In the case of a tax-exempt bond, basis shall be reduced by the amount of the amortizable bond premium disallowable as a deduction under section 171 (a) (2), or under section 125 (a) (2) of the Internal Revenue Code of 1939 and, in the case of any other bond (as defined in section 171 (d)), basis shall be reduced by the amount of the deductions allowable under section 171 (a) (1), or under section 125 (a) (1) of the Internal Revenue Code of 1939.

(c) *Short-term municipal bonds.* In the case of a short-term municipal bond (as defined in section 75 (b)), basis shall be adjusted to the extent provided in section 75, or as provided in section 22(o) of the Internal Revenue Code of 1939, and the regulations thereunder.

(d) *Sale or exchange of residence.* Where the acquisition of a new residence results in the nonrecognition of any part of the gain on the sale, exchange, or involuntary conversion of the old residence, the basis of the new residence shall be reduced by the amount of the gain not so recognized pursuant to section 1034 (a), or section 112 (n) of the Internal Revenue Code of 1939, and the regulations thereunder. See section 1034 (e) and the regulations thereunder.

(e) *Loans from Commodity Credit Corporation.* In the case of property pledged to the Commodity Credit Corporation, the basis of such property shall be increased by the amount received as a loan from such corporation and treated by the taxpayer as income for the year in which received under section 77, or under section 123 of the Internal Revenue Code of 1939. The basis of such property shall be reduced to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability.

(f) *Deferred development and exploration expenses.* Expenditures for development and exploration of mines or mineral deposits treated as deferred expenses under sections 615 and 616, or under the corresponding provisions of prior income tax laws, are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered as the "tax-benefit amount allowed" and shall be determined in accordance with paragraph (e) of § 1.1016–3. For example, if a taxpayer purchases unexplored and undeveloped mining property for $1,000,000 and at the close of the development stage has incurred exploration and development costs of $9,000,000 treated as deferred expenses, the basis of such property at such time for computing gain or loss will be $10,000,000. Assuming that the taxpayer in this example has operated the mine for several years and has deducted allowable percentage depletion in the amount of $2,000,000 and has deducted allowable deferred exploration and development expenditures of $2,000,000, the basis of the property in the taxpayer's hands for purposes of determining gain or loss from a sale will be $6,000,000.

(g) *Sale of land with unharvested crop.* In the case of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 1231, the basis of such crop shall be increased by the amount of the items which are attributable to the production of such crop and which are disallowed, under section 268, as deductions in computing taxable income. The basis of any other property shall be decreased by the amount of any such items which are attributable to such other property, notwithstanding any provisions of section 1016 or of this section to the contrary. For example, if the items attributable to the production of an unharvested crop consist only of fertilizer costing $100 and $50 depreciation on a tractor used only to cultivate such crop, and such items are disallowed under section 268, the adjustments to the basis of such crop shall include an increase of $150 for such items and the adjustments to the basis of the tractor shall include a reduction of $50 for depreciation.

(h) *Consent dividends.* (1) In the case of amounts specified in a shareholder's consent to which section 28 of the Internal Revenue Code of 1939 applies, the basis of the consent stock shall be increased to the extent provided in subsection (h) of such section.

(2) In the case of amounts specified in a shareholder's consent to be treated as a consent dividend to which section 565 applies, the basis of the consent stock shall be increased by the amount which, under section 565 (c) (2), is treated as contributed to the capital of the corporation.

(i) *Stock in foreign personal holding company.* In the case of the stock of a United States shareholder in a foreign personal holding company, basis shall be adjusted to the extent provided in section 551 (f) or corresponding provisions of prior income tax laws.

(j) *Research and experimental expenditures.* Research and experimental expenditures treated as deferred expenses under section 174 (b) are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2 relating to tax on self-employment income) of the Code, or prior income, war-profits, or excess-profits tax laws, but not less than the amounts allowable under such provisions for the taxable year and prior years. This amount is considered as the "tax-benefit amount allowed" and shall be determined in accordance with paragraph (e) of § 1.1016–3.

(k) *Deductions disallowed in connection with disposal of coal.* Basis shall be adjusted by the amount of the deductions disallowed under section 272 with respect to the disposal of coal covered by section 631.

(l) *Expenditures attributable to grants or loans covered by section 621.* In the case of expenditures attributable to a grant or loan made to a taxpayer by the United States for the encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, basis shall be adjusted to the extent provided in section 621, or in section 22 (b) (15) of the Internal Revenue Code of 1939.

(m) *Trademark and trade name expenditures.* Trademark and trade name expenditures treated as deferred expenses under section 177 are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The basis so adjusted shall be reduced by the amount of such expenditures allowed as deductions which results in a reduction for any taxable year of the taxpayer's taxes under subtitle A (other than chapter 2, relating to tax on self-employment income) of the Code, but not less than the amounts allowable under such section for the taxable year and prior years. This amount is considered as the "tax-benefit amount allowed" and shall be determined in accordance with paragraph (e) of § 1.1016–3.

§ 1.1016–6 Other applicable rules.

(a) Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

(b) In determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Code, and prior internal revenue laws.

§ 1.1016–7 Adjusted basis; cancellation of indebtedness under Bankruptcy Act.

(a) In addition to the adjustments provided in section 1016, further adjustment is required in the case of a cancellation or reduction of indebtedness in any proceeding under chapters X, XI, or XII of the Bankruptcy Act (11 U. S. C. ch. 10, 11, and 12) and corresponding provisions of prior law. For exceptions to the above rule see sections 372, 373, 374, and 1018. Furthermore, no such further adjustment will be made in the case of a "wage earner" as that term is defined in section 606 (8) of the Bankruptcy Act (11 U.S.C. 1006 (8). The further adjustments required by this section shall be made in the following manner and order:

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been canceled or reduced in any such proceeding, the cost or other basis

of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness so incurred with respect to such property shall have been canceled or reduced;

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the cancellation or reduction of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness secured by such lien shall have been canceled or reduced;

(3) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced in such proceeding over the sum of the adjustments made under subparagraphs (1) and (2) of this paragraph shall next be applied to reduce the cost or other basis of the property of the debtor (other than inventory and notes and accounts receivable, but including property covered by such subparagraphs) as follows: the cost or other basis of each unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis (after adjustment under subparagraphs (1) and (2) of this paragraph) of each such unit of property bears to the sum of the adjusted bases (after adjustment under such subparagraphs) of all the property of the debtor other than inventory and notes and accounts receivable;

(4) Any excess of the total amount by which such indebtedness shall have been so canceled or reduced over the sum of the adjustments made under subparagraphs (1), (2), and (3), of this paragraph shall next be applied to reduce the cost or other basis of any units of property covered by such subparagraphs which have a remaining basis (after adjustment under such subparagraphs) greater than their fair market value, as follows: the cost or other basis of each such unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the remaining basis of each such unit bears to the sum of the remaining bases of such units. The process shall be repeated until the cost or other basis of each unit of the property covered by subparagraphs (1), (2), and (3) of this paragraph is reduced to its fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value; and

(5) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced over the sum of the adjustments made under subparagraphs (1), (2), (3), and (4) of this paragraph shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable as follows: the cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable. The process shall be repeated until the adjusted bases of inventory, notes receivable, and accounts receivable are reduced to their fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value.

(b) For the purposes of this section:

(1) Basis shall be determined as of the dates of entry of the order confirming the plan, composition, or arrangement under which such indebtedness shall have been canceled or reduced;

(2) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(3) No adjustment shall be made by virtue of the cancellation or reduction of any accrued interest unpaid which shall not have resulted in a tax benefit in any income tax return;

(4) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay; and

(5) The term "fair market value" has reference to such value as of the date of entry of the order confirming the plan, composition, or arrangement under which such indebtedness shall have been canceled or reduced.

(c) Any determination of value in a proceeding under the Bankruptcy Act (11 U. S. C. 1 et seq.), shall not constitute a determination of fair market value for the purpose of this section.

(d) The basis of any of the debtor's property which shall have been transferred to a person required to use the debtor's basis in whole or in part shall be determined in accordance with the provisions of this section.

§ 1.1016–8 Adjusted basis; cancellation of indebtedness; special cases.

If the taxpayer and the Commissioner agree, the basis of the taxpayer's property may be adjusted in a manner different from that set forth in § 1.1016–7. Variations from such rule may, for example, involve adjusting the basis of any part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation. Agreement between the taxpayer and the Commissioner as to any variation from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121.

§ 1.1016–9 Adjusted basis; mutual savings banks, building and loan associations, and cooperative banks.

(a) The adjustments to the cost or other basis of property provided in section 1016 and §§ 1.1016–1 to 1.1016–8, inclusive, are applicable in the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, although such institutions were exempt from tax for taxable years beginning before January 1, 1952. Proper adjustment must be made under section 1016 for the entire period since the acquisition of property. Thus, adjustment to basis must be made for depreciation sustained for all prior taxable years although such institution may have been exempt from tax during such years. Similarly, in the case of tax-exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond (or in the case of bonds not issued with interest coupons, or in registered form, from the date such bonds are subject to amortization under section 171).

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. On January 1, 1954, Z, a mutual savings bank, which keeps its books on a calendar year basis, owns a tax-exempt $1,000 noncallable bond maturing on January 1, 1964. Such bond was acquired by Z on January 1, 1934, for $1,300. It was sold by Z on December 31, 1954, for $1,250. The yearly rate of amortization of the premium, determined by dividing the total premium of $300 by the life of the bond (30 years) is $10. Z realizes a gain of $80 from such sale computed as follows:

(1) Cost of bond		$1,300
(2) Amount of bond premium attributable to years 1942 through 1951, during which Z was exempt from tax ($10 times 10 years)	$100	
(3) Amount of bond premium amortized from Jan. 1, 1952, through Dec. 31, 1954 ($10 times 3 years)	30	
(4) Total amount of adjustments to basis (aggregate of (2) and (3))		130
(5) Adjusted basis of bond at close of 1954 ((1) reduced by (4))		1,170
(6) Gain realized upon sale—excess of sale price over adjusted basis ($1,250 minus $1,170)		80

The basis of a fully taxable bond purchased at a premium shall be adjusted from the date to which the election applies to amortize such premium in accordance with the provisions of section 171, except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(c) In the case of a mortgage (not within the definition of section 171 (d)) purchased, acquired, or originated at a premium, where the principal of such mortgage is payable in installments, adjustments to the basis of the premium must be made for all taxable years (whether or not the institution was exempt from tax during such years) in which installment payments are received.

Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such institution. For the purpose of this adjustment, the term "premium" includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees, or brokerage fees, but such value does not include amounts paid for accrued interest. For the method of amortization in the case of corporate mortgages purchased, acquired, or originated at a premium, see paragraph (e) of § 1.171–2.

§ 1.1016–10 Substituted basis.

(a) Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016 (b), the adjustments indicated in §§ 1.1016–1 to 1.1016–6, inclusive, shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. In addition, whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, as defined in section 1016 (b) (1), the adjustments indicated in §§ 1.1016–7 to 1.1016–9, inclusive, and in section 1017 shall also be made, whenever necessary, after first making in respect of such substituted basis a proper adjustment of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor. Similar rules shall also be applied in the case of a series of substituted bases.

(b) The application of this section may be illustrated by the following example:

Example. A, who makes his returns upon the calendar year basis, in 1935 purchased the X Building and subsequently gave it to his son B. B exchanged the X Building for the Y Building in a tax-free exchange, and then gave the Y Building to his wife C. C, in determining the gain from the sale or disposition of the Y Building in 1954, is required to reduce the basis of the building by deductions for depreciation which were successively allowed (but not less than the amount allowable) to A and B upon the X Building and to B upon the Y Building, in addition to the deductions for depreciation allowed (but not less than the amount allowable) to herself during her ownership of the Y Building.

§ 1.1017 Statutory provisions; discharge of indebtedness.

SEC. 1017. *Discharge of indebtedness.* Where any amount is excluded from gross income under section 108 (a) (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 108 (a)) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary or his delegate) in effect at the time of the filing of the consent by the taxpayer referred to in section 108 (a). The reduction shall be made as of the first day of the taxable year in which the discharge occurred, except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began.

§ 1.1017–1 Adjusted basis; discharge of indebtedness; general rule.

(a) In addition to the adjustments provided in section 1016 and the regulations thereunder which are required to be made with respect to the cost or other basis of property, and except as otherwise provided in section 372(a), 373(b)(2), or 1018, a further adjustment shall be made in any case in which there shall have been an exclusion from gross income under section 108 (a) on account of a discharge of indebtedness during the taxable year. Such further adjustments shall, except as otherwise provided in § 1.1017–2, be made in the following manner and order (but in the case of an individual, subparagraphs (1) to (4), inclusive, of this paragraph, shall apply only to property used in any trade or business of such individual):

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable), whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been discharged, the cost or other basis of such property shall be decreased by an amount equal to the amount excluded from gross income under section 108 (a) and attributable to the discharge of the indebtedness so incurred with respect to such property;

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the discharge of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property), the cost or other basis of such property shall be decreased by an amount equal to the amount excluded from gross income under section 108 (a) and attributable to the discharge of the indebtedness secured by such lien;

(3) Any excess of the total amount excluded from gross income under section 108 (a) over the sum of the adjustments made under subparagraphs (1) and (2) of this paragraph shall next be applied to reduce the cost or other basis of all the property of the debtor (other than inventory and notes and accounts receivable) as follows: The cost or other basis of each unit of property shall be decreased in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of adjusted bases (without reference to this section) of all the property of the debtor other than inventory and notes and accounts receivable;

(4) Any excess of the total amount excluded from gross income under section 108 (a) over the sum of the adjustments made under subparagraphs (1), (2), and (3) of this paragraph shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable, as follows: The cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable;

(5) In the case of an individual, any excess of the total amount excluded from gross income under section 108 (a) over the sum of the adjustments made under subparagraphs (1), (2), (3), and (4) of this paragraph shall next be applied to reduce the cost or other basis of his property held for the production of income, as follows: The cost or other basis of each unit of such property shall be decreased in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of the adjusted bases (without reference to this section) of all of such property of the debtor; and

(6) In the case of an individual, any excess of the total amount excluded from gross income under section 108 (a) over the sum of the adjustments made under subparagraphs (1), (2), (3), (4), and (5) of this paragraph shall next be applied to reduce the cost or other basis of his property other than property used in any trade or business and property held for the production of income, as follows: The cost or other basis of each unit of such property shall be decreased in an amount equal to such proportion of such excess as the adjusted basis (without reference to this section) of each such unit of property bears to the sum of the adjusted bases (without reference to this section) of all of such property of the debtor.

In the application of subparagraphs (1), (2), (3), (4), (5) and (6) of this paragraph, no decrease in the cost or other basis of any property shall exceed the amount of adjusted basis of such property without reference to this section.

(b) For the purposes of this section:

(1) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(2) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay;

(3) The phrase "amount excluded from gross income under section 108 (a)" means the amount of income excluded under that section reduced by any deduction disallowed under that section for unamortized discount;

(4) Adjustments to basis shall be made:

(i) In the case of property owned on the first day of the taxable year, as of that day;

(ii) In the case of property acquired after the first day of the taxable year, as of the day so acquired—

regardless of the time such property was subsequently sold, exchanged, or otherwise disposed of by the taxpayer;

(5) Whenever a discharge of indebtedness is accomplished by a transfer of the taxpayer's property in kind, the difference between the amount of the obligation discharged and the fair market value of the property transferred is the amount which may be applied in reduction of basis;

(6) Regardless of the amount excluded by the taxpayer from his gross income under section 108 (a) and so stated on Form 982, the maximum amount by which basis may be reduced in respect of the discharge of any indebtedness is the amount of income resulting from the discharge of such indebtedness; and

(7) Any reduction in basis which remains to be taken (by reason of an exclusion from gross income under section 108 (a)) after the application of paragraph (a) (1) of this section shall be applied first against property of a character subject to the allowance for depreciation under section 167, property with respect to which a deduction for amortization is allowable under section 168 or 169, and property with respect to which a deduction for depletion is allowable under section 611 (but not including property specified in section 613), in the order in which such property is described in paragraph (a) (2) and (3) of this section. This section shall not be applicable to property with respect to which basis is reduced under paragraph (a) (5) and (6) of this section. Any further adjustment in basis required to be made under section 108 (a) shall be applied against other property in the order prescribed in paragraph (a) (2), (3), (4), (5), and (6) of this section.

(c) The application of paragraph (a) of this section may be illustrated by the following examples:

Example (1). On January 1, 1954, the N Corporation owned an office building, which it sold in March 1954. In June 1954 it purchased a factory building. In October 1954 the N Corporation bought in its outstanding bonds at less than their face value. Assuming that there is a proper exclusion from gross income under section 108 (a), the basis of each building shall be adjusted under section 1017 for the taxable year 1954. (But see § 1.1017–2.)

Example (2). The M Corporation had outstanding an issue of A bonds which it had sold at a premium and an issue of B bonds which it had sold at a discount. In July 1954 the M Corporation purchased such outstanding bonds for less than face value. The amount of income attributable to the discharge of the A bonds is $1,000 and the amount of unamortized premium (as of the first day of the taxable year in which the discharge occurred) is $200. The amount of income attributable to the discharge of the B bonds is $1,000 and the amount of unamortized discount (as of the first day of the taxable year in which the discharge occurred) is $50. Each issue of bonds is regarded as a separate indebtedness and the M Corporation may elect under section 108 (a) with respect to each issue or both issues. If the M Corporation elects under section 108 (a) to have excluded from gross income the amount of income attributable to the discharge of the issue of A bonds, the total reduction in basis of property of the M Corporation shall not exceed $1,200. If the M Corporation elects with respect to the B bonds, the total reduction in basis shall not exceed $950. If the M Corporation elects with respect to both bond issues, the total reduction in basis shall not exceed $2,150.

§ 1.1017–2 Adjusted basis; discharge of indebtedness; special cases.

(a) Section 1.1017–1 prescribes the general rule to be followed in adjusting basis of property where there is a proper exclusion from gross income under section 108(a). The taxpayer may, however, have the basis of his property adjusted in a manner different from that set forth in § 1.1017–1 upon a proper showing to the satisfaction of the Commissioner. Such adjustment, however, shall be consistent with the principles of § 1.1017–1. Variations from such general rule may, for example, involve adjusting the basis of only part of the taxpayer's property or adjusting the basis of all the taxpayer's property, according to a fixed allocation.

(b) A request for variations from the general rule prescribed in § 1.1017–1 shall be filed by the taxpayer with his return for the taxable year in which the discharge of indebtedness occurred unless a consent is permitted (under § 1.108 (a)–2) after the original return has been filed, in which case such request shall be filed with the amended return or claim for credit or refund, as the case may be. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule prescribed in § 1.1017–1, then the consent filed on Form 982 shall be deemed to be a consent to the application of such general rule and such general rule shall prevail in the determination of the basis of the taxpayer's property. If no agreement is reached between the taxpayer and the Commissioner as to variations from the general rule and the taxpayer specifically states that he does not consent to the application of the general rule, then section 108 (a) and section 1017 shall not apply.

§ 1.1018 Statutory provisions; adjustment of capital structure before September 22, 1938.

SEC. 1018. *Adjustment of capital structure before September 22, 1938.* Where a plan of reorganization of a corporation, approved by the court in a proceeding under section 77B of the National Bankruptcy Act, as amended (48 Stat. 912), is consummated by adjustment of the capital or debt structure of such corporation without the transfer of its assets to another corporation, and a final judgment or decree in such proceeding has been entered before September 22, 1938, then the provisions of section 270 of the Bankruptcy Act, as amended (54 Stat. 709; 11 U. S. C. 670), shall not apply in respect of the property of such corporation. For the purposes of this section, the term "reorganization" shall not be limited by the definition of such term in section 112 (g) of the Internal Revenue Code of 1939.

§ 1.1018–1 Adjusted basis; exception to section 270 of the Bankruptcy Act, as amended.

The adjustment to basis provided by section 270 of the Bankruptcy Act, as amended (11 U.S.C. 670), and by §§ 1.1016–7 and 1.1016–8 shall not be made if, in a proceeding under section 77B of such Act, as amended (11 U. S. C. 207; 48 Stat. 912), indebtedness was canceled in pursuance of a plan of reorganization which was consummated by adjustment of the capital or debt structure of the insolvent corporation, and the final judgment or decree in such proceeding was entered before September 22, 1938. Section 1018 and this section do not apply if the plan of reorganization under such section 77B was consummated by the transfer of assets of the insolvent corporation to another corporation.

§ 1.1019 Statutory provisions; property on which lessee has made improvements.

SEC. 1019. *Property on which lessee has made improvements.* Neither the basis nor the adjusted basis of any portion of real property shall, in the case of the lessor of such property, be increased or diminished on account of income derived by the lessor in respect of such property and excludable from gross income under section 109 (relating to improvements by lessee on lessor's property). If an amount representing any part of the value of the real property attributable to buildings erected or other improvements made by a lessee in respect of such property was included in gross income of the lessor for any taxable year beginning before January 1, 1942, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income.

§ 1.1019–1 Property on which lessee has made improvements.

In any case in which a lessee of real property has erected buildings or made other improvements upon the leased property and the lease is terminated by forfeiture or otherwise resulting in the realization by such lessor of income which, were it not for the provisions of section 109, would be includible in gross income of the lessor, the amount so excluded from gross income shall not be taken into account in determining the basis or the adjusted basis of such property or any portion thereof in the hands of the lessor. If, however, in any taxable year beginning before January 1, 1942, there has been included in the gross income of the lessor an amount representing any part of the value of such property attributable to such buildings or improvements, the basis of each portion of such property shall be properly adjusted for the amount so included in gross income. For example, A leased in 1930 to B for a period of 25 years unimproved real property and in accordance with the terms of the lease B erected a building on the property. It was estimated that upon expiration of the lease the building would have a depreciated value of $50,000, which value the lessor elected to report (beginning in 1931) as income over the term of the lease. This method of reporting was used until 1942. In 1952 B forfeits the lease. The amount of $22,000 reported as income by A during the years 1931 to 1941, inclusive, shall be added to the basis of the property

represented by the improvements in the hands of A. If in such case A did not report during the period of the lease any income attributable to the value of the building erected by the lessee and the lease was forfeited in 1940 when the building was worth $75,000, such amount, having been included in gross income under the law applicable to that year, is added to the basis of the property represented by the improvements in the hands of A. As to treatment of such property for the purposes of capital gains and losses, see subchapter P (section 1201 and following), chapter 1 of the Code.

§ 1.1020 Statutory provisions; election in respect of depreciation, etc., allowed before 1952.

SEC. 1020. *Election in respect of depreciation, etc., allowed before 1952.* Any person may elect to have subparagraph (B) of section 1016 (a) (2) apply in respect of periods since February 28, 1913, and before January 1, 1952. Such an election shall be made in such manner as the Secretary or his delegate may by regulations prescribe and shall be irrevocable when made, except that an election made on or before December 31, 1952, may be revoked at any time before January 1, 1955. A revocation of an election shall be made in such manner as the Secretary or his delegate may by regulations prescribe, and no election may be made by any person after he has so revoked an election. The election shall apply in respect of all property held by the person making the election at any time on or before December 31, 1952, and in respect of all periods since February 28, 1913, and before January 1, 1952, during which such person held such property or for which adjustments must be made under section 1016 (b). An election or a revocation of an election by a transferor, donor, or grantor made after the date of the transfer, gift, or grant of property shall not affect the basis of such property in the hands of the transferee, donee, or grantee. No election may be made under this section after December 31, 1954.

§ 1.1020–1 Election as to amounts allowed in respect of depreciation, etc., before 1952.

(a) *In general.* (1) Any person may elect to have the adjustments to the cost or other basis of property under section 1016 (a) (2) determined in accordance with subparagraph (B) of such section by filing a statement of election in accordance with the requirements set forth in paragraph (b) of this section. Any election made after 1952 shall be irrevocable when made. Any election made after 1952 shall apply with respect to all property held by the person making the election at any time on or before December 31, 1952, and shall apply to all periods since February 28, 1913, and before January 1, 1952, during which such person held such property or for which adjustments must be made under section 1016 (b). For rules with respect to an election made on or before December 31, 1952, see paragraph (c) of this section.

(2) An election by a partner on his own behalf is not an election for the partnership of which he is a member. A separate election must be made on behalf of the partnership. (See section 703 (b) (relating to elections of the partnership).) An election on behalf of the partnership applies only with respect to the partnership, and does not apply to the separate property of the partners. A similar rule applies with respect to elections by trusts and beneficiaries of trusts. These rules also apply with respect to a revocation of an election where such election was made on or before December 31, 1952.

(b) *Rules applicable to making of election.* The following rules are applicable to the making of an election under section 1020:

(1) *Form of election.* The election shall be in the form of a statement in writing, shall state the name and address of the taxpayer making the election, and shall contain a statement that such taxpayer elects to have the provisions of section 1016 (a) (2) (B) apply in respect of all periods since February 28, 1913, and before January 1, 1952.

(2) *Signature.* The statement shall be signed by the taxpayer making the election, if an individual, or, if the taxpayer making the election is not an individual, the statement shall be signed by the person or persons required to sign the income return of such taxpayer.

(3) *Filing.* The statement must be filed on or before December 31, 1954, in the office of the district director for the internal revenue district in which the income tax return for the year of the election is required to be filed. For rules as to when timely mailing will be treated as timely filing of the statement see section 7502.

(4) *Filing of duplicate.* A copy of the statement of election must be filed with the first return, amended return, or claim for refund filed on or after the date on which the election is made.

(c) *Election made on or before December 31, 1952.* An election made on or before December 31, 1952, in accordance with the provisions of section 113 (d) of the Internal Revenue Code of 1939, may be revoked by filing on or before December 31, 1954, in the same office in which the election was filed, a statement of revocation signed in the same manner as the election. Such statement made by any person is irrevocable when made with respect to such person, and no new election may thereafter be made by such person. A copy of the revocation must be filed with the first return, amended return, or claim for refund, filed after the date of the revocation. For additional rules with respect to election made on or before December 31, 1952, see 26 CFR (1939) 39.113 (b) (1)–1 (Regulations 118).

(d) *Validity of elections or revocation of elections.* An election or revocation of an election which conforms in substance to the provisions of this section will not be deemed invalid solely because it was filed before the date on which the regulations in this section were promulgated.

(e) *Effect of election.* For rules relating to the effect of an election under this section, see section 1016 (a) (2) and the regulations thereunder.

§ 1.1021 Statutory provisions; sale of annuities.

SEC. 1021. *Sale of annuities.* In case of the sale of an annuity contract, the adjusted basis shall in no case be less than zero.

§ 1.1021–1 Sale of annuities.

In the case of a transfer for value of an annuity contract to which section 72(g) and paragraph (a) of § 1.72–10 apply, the transferor shall adjust his basis in such contract as of the time immediately prior to such transfer by subtracting from the premiums or other consideration he has paid or is deemed to have paid for such contract all amounts he has received or is deemed to have received under such annuity contract to the extent that such amounts were not includible in the gross income of the transferor or other recipient under the applicable income tax law. In any case where the amounts which were not includible in the gross income of the recipient were received or deemed to have been received by such transferor exceed the amounts paid or deemed paid by him, the adjusted basis of the contract shall be zero. The income realized by the transferor on such a transfer shall not exceed the total of the amounts received as consideration for the transfer.

§ 1.1022 Statutory provisions; cross references.

SEC. 1022. *Cross references.* (1) For certain distributions by a corporation which are applied in reduction of basis of stock, see section 301 (c) (2).

(2) For basis of property in case of certain reorganizations and arrangements under the Bankruptcy Act, see sections 270, 396, and 522 of that Act, as amended (11 U. S. C. 670, 796, 922).

(3) For basis in case of construction of new vessels, see section 511 of the Merchant Marine Act, 1936, as amended (46 U. S. C. 1161).

(4) For rules applicable in case of payments in violation of Defense Production Act of 1950, as amended, see section 405 of that Act.

COMMON NONTAXABLE EXCHANGES

§ 1.1031(a) Statutory provisions; exchange of property held for productive use or investment; nonrecognition of gain or loss from exchanges solely in kind.

SEC. 1031. *Exchange of property held for productive use or investment—(a) Nonrecognition of gain or loss from exchanges solely in kind.* No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

§ 1.1031(a)–1 Property held for productive use in trade or business or for investment.

(a) Section 1031(a) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. See section 1002 and the regulations thereunder. Under section 1031 (a), no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in trade or business or

for investment. Under section 1031 (a), property held for productive use in trade or business may be exchanged for property held for investment. Similarly, property held for investment may be exchanged for property held for productive use in trade or business. However, section 1031 (a) provides that property held for productive use in trade or business or for investment does not include stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest. A transfer is not within the provisions of section 1031 (a) if as part of the consideration the taxpayer receives money or property which does not meet the requirements of section 1031 (a), but the transfer, if otherwise qualified, will be within the provisions of section 1031 (b). Similarly, a transfer is not within the provisions of section 1031 (a) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031 (b). A transfer of property meeting the requirements of section 1031 (a) may be within the provisions of section 1031 (a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031 (a) or money. However, the nonrecognition treatment provided by section 1031 (a) does not apply to the property transferred which does not meet the requirements of section 1031 (a).

(b) As used in section 1031 (a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

(c) No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) Gain or loss is recognized if, for instance, a taxpayer exchanges (1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, or (2) a real estate mortgage for consolidated farm loan bonds.

§ 1.1031(b) Statutory provisions; exchange of property held for productive use or investment; gain from exchanges not solely in kind.

SEC. 1031. *Exchange of property held for productive use or investment* * * *

(b) *Gain from exchanges not solely in kind.* If an exchange would be within the provisions of subsection (a), of section 1035 (a), or of section 1036 (a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

§ 1.1031(b)–1 Receipt of other property or money in tax-free exchange.

(a) If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money (1) in an exchange described in section 1031 (a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment, or (2) in an exchange described in section 1035 (a) of insurance policies or annuity contracts, or (3) in an exchange described in section 1036 (a) of common stock for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization, then:

(i) The gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property, but

(ii) The loss, if any, to the taxpayer from such an exchange will not be recognized to any extent (see section 1031 (c)).

(b) The application of this section may be illustrated by the following example:

Example. A, who is not a dealer in real estate, in 1954 exchanges real estate held for investment, which he purchased in 1940 for $5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and $2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

(c) Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for the purposes of section 1031 (b). Where, on an exchange described in section 1031 (b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of "other property or money" for purposes of section 1031 (b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). See § 1.1031 (d)–2, examples (1) and (2).

§ 1.1031(c) Statutory provisions; exchange of property held for productive use or investment; loss from exchanges not solely in kind.

SEC. 1031. *Exchange of property held for productive use or investment.* * * *

(c) *Loss from exchanges not solely in kind.* If an exchange would be within the provisions of subsection (a), of section 1035 (a), or of section 1036 (a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

§ 1.1031(c)–1 Nonrecognition of loss.

Section 1031(c) provides that a loss shall not be recognized from an exchange of property described in section 1031(a), 1035(a), or 1036(a) where there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss.

§ 1.1031(d) Statutory provisions; exchange of property held for productive use or investment; basis.

SEC. 1031. *Exchange of property held for productive use or investment.* * * *

(d) *Basis.* If property was acquired on an exchange described in this section, section 1035(a), or section 1036(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), or section 1036(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall be considered as money received by the taxpayer on the exchange.

[Sec. 1031(d) as amended by sec. 44, Technical Amendments Act 1958 (72 Stat. 1641)]

§ 1.1031(d)–1 Property acquired upon a tax-free exchange.

(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), or section 1036(a), no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

(b) If, in an exchange of properties of the type indicated in section 1031, section 1035 (a), or section 1036 (a), gain to the taxpayer was recognized under the provisions of section 1031 (b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the

exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. The application of this paragraph may be illustrated by the following example:

Example. A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of $2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of $2,400 and $200 in cash. A realizes a gain of $100 upon the exchange, all of which is recognized under section 1031 (b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck	$2,500
Less: Amount of money received	200
Difference	2,300
Plus: Amount of gain recognized	100
Basis of truck acquired by A	2,400

(c) If, upon an exchange of properties of the type described in section 1031, section 1035 (a), or section 1036 (a), the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031 (b), or a similar provision of a prior revenue law, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis to the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example. A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for $10,000 in exchange for other real estate (to be held for investment) which has a fair market value of $9,000, an automobile which has a fair market value of $2,000, and $1,500 in cash. A realizes a gain of $2,500, all of which is recognized under section 1031 (b). The basis of the property received in exchange is the basis of the real estate A transfers ($10,000) decreased by the amount of money received ($1,500) and increased in the amount of gain that was recognized ($2,500), which results in a basis for the property received of $11,000. This basis of $11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, $2,000, and the basis of the real estate received being the remainder, $9,000.

(d) Section 1031 (c) and, with respect to section 1031 and section 1036 (a), similar provisions of prior revenue laws provide that no loss may be recognized on an exchange of properties of a type described in section 1031, section 1035 (a), or section 1036 (a), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be allocated to the properties received, and for this purpose there must be allocated to such other property an amount of such basis equivalent to its fair market value at the date of the exchange.

(e) If, upon an exchange of properties of the type described in section 1031, section 1035(a), or section 1036(a), the taxpayer also exchanged other property (not permitted to be transferred without the recognition of gain or loss) and gain or loss from the transaction is recognized under section 1002 or a similar provision of a prior revenue law, the basis of the property acquired is the total basis of the properties transferred (adjusted to the date of the exchange) increased by the amount of gain and decreased by the amount of loss recognized on the other property. For purposes of this rule, the taxpayer is deemed to have received in exchange for such other property an amount equal to its fair market value on the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example. A exchanges real estate held for investment plus stock for real estate to be held for investment. The real estate transferred has an adjusted basis of $10,000 and a fair market value of $11,000. The stock transferred has an adjusted basis of $4,000 and a fair market value of $2,000. The real estate acquired has a fair market value of $13,000. A is deemed to have received a $2,000 portion of the acquired real estate in exchange for the stock, since $2,000 is the fair market value of the stock at the time of the exchange. A $2,000 loss is recognized under section 1002 on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. The basis of the real estate acquired by A is determined as follows:

Adjusted basis of real estate transferred	$10,000	
Adjusted basis of stock transferred	4,000	
		14,000
Less: Loss recognized on transfer of stock		2,000
Basis of real estate acquired upon the exchange		12,000

§ 1.1031(d)–2 Treatment of assumption of liabilities.

For the purposes of section 1031(d), the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

Example (1). B, an individual, owns an apartment house which has an adjusted basis in his hands of $500,000, but which is subject to a mortgage of $150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor $50,000 in cash and another apartment house with a fair market value on that date of $600,000. The transfer to C is made subject to the $150,000 mortgage. B realizes a gain of $300,000 on the exchange, computed as follows:

Value of property received	$600,000	
Cash	50,000	
Liabilities subject to which old property was transferred	150,000	
Total consideration received		800,000
Less: Adjusted basis of property transferred		500,000
Gain realized		300,000

Under section 1031 (b), $200,000 of the $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows:

Adjusted basis of property transferred		$500,000
Less: Amount of money received:		
Cash	$50,000	
Amount of liabilities subject to which property was transferred	150,000	
		200,000
Difference		300,000
Plus: Amount of gain recognized upon the exchange		200,000
Basis of property acquired upon the exchange		500,000

Example (2). (a) D, an individual, owns an apartment house. On December 1, 1955, the apartment house owned by D has an adjusted basis in his hands of $100,000, a fair market value of $220,000, but is subject to a mortgage of $80,000. E, an individual, also owns an apartment house. On December 1, 1955, the apartment house owned by E has an adjusted basis of $175,000, a fair market value of $250,000, but is subject to a mortgage of $150,000. On December 1, 1955, D transfers his apartment house to E, receiving in exchange therefor $40,000 in cash and the apartment house owned by E. Each apartment house is transferred subject to the mortgage on it.

(b) D realizes a gain of $120,000 on the exchange, computed as follows:

Value of property received	$250,000	
Cash	40,000	
Liabilities subject to which old property was transferred	80,000	
Total consideration received		370,000
Less:		
Adjusted basis of property transferred	$100,000	
Liabilities to which new property is subject	150,000	
		250,000
Gain realized		120,000

For purposes of section 1031 (b), the amount of "other property or money" received by D is $40,000. (Consideration received by D in the form of a transfer subject to a liability of $80,000 is offset by consideration given in the form of a receipt of property subject to a $150,000 liability. Thus, only the consideration received in the form of cash, $40,000, is treated as "other property or money" for purposes of section 1031 (b).) Accordingly, under section 1031 (b), $40,000 of the $120,000 gain is recognized. The basis of the apartment house acquired by D is $170,000, computed as follows:

Adjusted basis of property transferred		$100,000
Liabilities to which new property is subject		150,000
Total		250,000
Less: Amount of money received:		
Cash	$40,000	
Amount of liabilities subject to which property was transferred	80,000	
		120,000
Difference		130,000
Plus: Amount of gain recognized upon the exchange		40,000
Basis of property acquired upon the exchange		170,000

(c) **E** realizes a gain of $75,000 on the exchange, computed as follows:

Value of property received		$220,000
Liabilities subject to which old property was transferred		150,000
Total consideration received		370,000
Less:		
Adjusted basis of property transferred	$175,000	
Cash	40,000	
Liabilities to which new property is subject	80,000	
		295,000
Gain realized		75,000

For purposes of section 1031 (b), the amount of "other property or money" received by **E** is $30,000. (Consideration received by **E** in the form of a transfer subject to a liability of $150,000 is offset by consideration given in the form of a receipt of property subject to an $80,000 liability and by the $40,000 cash paid by **E**. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031 (b), $30,000 of the $75,000 gain is recognized. The basis of the apartment house acquired by **E** is $175,000, computed as follows:

Adjusted basis of property transferred		$175,000
Cash		40,000
Liabilities to which new property is subject		80,000
Total		295,000
Less: Amount of money received: Amount of liabilities subject to which property was transferred	$150,000	
		$150,000
Difference		145,000
Plus: Amount of gain recognized upon the exchange		30,000
Basis of property acquired upon the exchange		175,000

§ 1.1032 Statutory provisions; exchange of stock for property.

SEC. 1032. *Exchange of stock for property*—(a) *Nonrecognition of gain or loss.* No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

(b) *Basis.* For basis of property acquired by a corporation in certain exchanges for its stock, see section 362.

§ 1.1032–1 Disposition by a corporation of its own capital stock.

(a) The disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved. For example, the receipt by a corporation of the subscription price of shares of its stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be equal to, in excess of, or less than, the par or stated value of such stock. Also, the exchange or sale by a corporation of its own shares for money or other property does not result in taxable gain or deductible loss, even though the corporation deals in such shares as it might in the shares of another corporation. A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered, for purposes of section 1032 (a), as a disposition by the corporation of such shares for money or other property.

(b) Section 1032 (a) does not apply to the acquisition by a corporation of shares of its own stock except where the corporation acquires such shares in exchange for shares of its own stock (including treasury stock). See paragraph (e) of § 1.311–1, relating to treatment of acquisitions of a corporation's own stock. Section 1032 (a) also does not relate to the tax treatment of the recipient of a corporation's stock.

(c) Where a corporation acquires shares of its own stock in exchange for shares of its own stock (including treasury stock) the transaction may qualify not only under section 1032 (a), but also under section 368 (a) (1) (E) (recapitalization) or section 305 (a) (distribution of stock and stock rights).

(d) For basis of property acquired by a corporation in connection with a transaction to which section 351 applies or in connection with a reorganization, see section 362. For basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualify under any other nonrecognition provision, see section 1012.

§ 1.1033(a) Statutory provisions; involuntary conversions; general rule.

SEC. 1033. *Involuntary conversions*—(a) *General rule.* If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) *Conversion into similar property.* Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) *Conversion into money where disposition occurred prior to 1951.* Into money, and the disposition of the converted property occurred before January 1, 1951, no gain shall be recognized if such money is forthwith in good faith, under regulations prescribed by the Secretary or his delegate, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund. If any part of the money is not so expended, the gain shall be recognized to the extent of the money which is not so expended (regardless of whether such money is received in one or more taxable years and regardless of whether or not the money which is not so expended constitutes gain). For purposes of this paragraph and paragraph (3), the term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation. For purposes of this paragraph and paragraph (3), the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(3) *Conversion into money where disposition occurred after 1950.* Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) *Nonrecognition of gain.* If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. For purposes of this paragraph—

(i) No property or stock acquired before the disposition of the converted property shall be considered to have been acquired for the purpose of replacing such converted property unless held by the taxpayer on the date of such disposition; and

(ii) The taxpayer shall be considered to have purchased property or stock only if, but for the provisions of subsection (c) of this section, the unadjusted basis of such property or stock would be its cost within the meaning of section 1012.

(B) *Period within which property must be replaced.* The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending—

(i) One year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or

(ii) Subject to such terms and conditions as may be specified by the Secretary or his delegate, at the close of such later date as the Secretary or his delegate may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe.

(C) *Time for assessment of deficiency attributable to gain upon conversion.* If a taxpayer has made the election provided in subparagraph (A), then—

(i) The statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain on such conversion is realized, attributable to such gain shall not expire prior to the expiration of 3

years from the date the Secretary or his delegate is notified by the taxpayer (in such manner as the Secretary or his delegate may by regulations prescribe) of the replacement of the converted property or of an intention not to replace, and

(ii) Such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212 (c) or the provisions of any other law or rule of law which would otherwise prevent such assessment.

(D) *Time for assessment of other deficiencies attributable to election.* If the election provided in subparagraph (A) is made by the taxpayer and such other property or such stock was purchased before the beginning of the last taxable year in which any part of the gain upon such conversion is realized, any deficiency, to the extent resulting from such election, for any taxable year ending before such last taxable year may be assessed (notwithstanding the provisions of section 6212 (c) or 6501 or the provisions of any other law or rule of law which would otherwise prevent such assessment) at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed.

[Sec. 1033(a) as amended by sec. 45, Technical Amendments Act 1958 (72 Stat. 1641)]

§ 1.1033(a)–1 Involuntary conversions; nonrecognition of gain.

(a) *In general.* Section 1033 applies to cases where property is compulsorily or involuntarily converted. An "involuntary conversion" may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. An "involuntary conversion" may be a conversion into similar property or into money or into dissimilar property. Section 1033 provides that, under certain specified circumstances, any gain which is realized from an involuntary conversion shall not be recognized. In cases where property is converted into other property similar or related in service or use to the converted property, no gain shall be recognized regardless of when the disposition of the converted property occurred and regardless of whether or not the taxpayer elects to have the gain not recognized. In other types of involuntary conversion cases, however, the proceeds arising from the disposition of the converted property must (within the time limits specified) be reinvested in similar property in order to avoid recognition of any gain realized. Different rules for reinvestment apply, depending upon whether the disposition of the converted property occurred after 1950 or before 1951 (see §§ 1.1033 (a)–2, 1.1033 (a)–3, and 1.1033 (a)–4). Section 1033 applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section.

(b) *Special rules.* For rules applicable to involuntary conversions of a principal residence occurring before January 1, 1951, see § 1.1033(b)–1. For rules applicable to involuntary conversions of a principal residence occurring after December 31, 1950, and before January 1, 1954, see paragraph (h)(1) of § 1.1034–1. For rules applicable to involuntary conversions of a personal residence occurring after December 31, 1953, see § 1.1033(b)–1. For special rules relating to the election to have section 1034 apply to certain involuntary conversions of a principal residence occurring after December 31, 1957, see paragraph (h)(2) of § 1.1034–1. For special rules relating to certain involuntary conversions of real property held either for productive use in trade or business or for investment and occurring after December 31, 1957, see § 1.1033(g)–1. See also special rules applicable to involuntary conversions of property sold pursuant to reclamation laws, livestock destroyed by disease, and livestock sold on account of drought provided in §§ 1.1033(d)–1, 1.1033(e)–1, and 1.1033(f)–1, respectively. For rules relating to basis of property acquired through involuntary conversions, see § 1.1033(c)–1. For determination of the period for which the taxpayer has held property acquired as a result of certain involuntary conversions, see section 1223 and regulations issued thereunder. For treatment of gains from involuntary conversions as capital gains in certain cases see section 1231(a) and regulations issued thereunder. For portion of war loss recoveries treated as gain on involuntary conversion, see section 1332(b)(3) and regulations issued thereunder.

§ 1.1033(a)–2 Involuntary conversion where disposition of the converted property occurred after December 31, 1950.

(a) *In general.* This section applies only with respect to involuntary conversions where the disposition of the converted property occurred after December 31, 1950, and where the proceeds are received in a taxable year to which the Internal Revenue Code of 1954 applies. The term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) *Conversion into similar property.* If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory.

(c) *Conversion into money or into dissimilar property.* (1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property which is purchased by the taxpayer in the acquisition of control of such corporation, if the taxpayer purchased such other property, or such stock, for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph. For the purposes of section 1033, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(2) All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 1033 (a) (3), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an "amended return". If a decision is made to make an election under section 1033 (a) (3) after the filing of the return and the payment of the tax for the year or years in which any of the gain on an involuntary conversion is realized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

(3) The period referred to in subparagraphs (1) and (2) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending one year after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date

as may be designated pursuant to an application of the taxpayer. Such application shall be made prior to the expiration of the one year after the close of the first taxable year in which any part of the gain from the conversion is realized, and shall contain all of the details in connection with the involuntary conversion. Such application shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the involuntary conversion is realized. No extension of time shall be granted pursuant to such application unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033 (c), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012. If the taxpayer's unadjusted basis of the replacement property would be determined, in the absence of section 1033 (c), under any of the exceptions referred to in section 1012, the unadjusted basis of the property would not be its cost within the meaning of section 1012. For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 1015, such property will not qualify as a replacement for the converted property.

(5) If a taxpayer makes an election under section 1033 (a) (3), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director with whom the return for such year has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of section 6212 (c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain all of the details in connection with such replacement. Such notification should be made in the return for the taxable year or years in which the replacement occurs, or the intention not to replace is formed, or the period for replacement expires, if this return is filed with such district director. If this return is not filed with such district director, then such notification shall be made to such district director at the time of filing this return. If the taxpayer so desires, he may, in either event, also notify such district director before the filing of such return.

(6) If a taxpayer makes an election under section 1033 (a) (3) and the replacement property or stock was purchased before the beginning of the last taxable year in which any part of the gain upon the conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212 (c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment.

(7) If the taxpayer makes an election under section 1033 (a) (3), the gain upon the conversion shall be recognized to the extent that the amount realized upon such conversion exceeds the cost of the replacement property or stock, regardless of whether such amount is realized in one or more taxable years.

(8) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(9) There is no investment in property similar in character and devoted to a similar use if—

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

(10) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation, the amount so retained shall be deducted from the gross award in determining the amount of the net award.

(11) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property, and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. If, in a condemnation proceeding, the Government makes an award to a mortgagee to satisfy a mortgage on the condemned property, the amount of such award shall be considered as a part of the "amount realized" upon the conversion regardless of whether or not the taxpayer was personally liable for the mortgage debt. Thus, if a taxpayer has acquired property worth $100,000 subject to a $50,000 mortgage (regardless of whether or not he was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer $60,000 and awards the mortgagee $50,000 in satisfaction of the mortgage, the entire $110,000 is considered to be the "amount realized" by the taxpayer.

(12) An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

§ 1.1033(a)–2 Involuntary conversion where disposition of the converted property occurred before January 1, 1951.

(a) This section applies only with respect to involuntary conversions where the disposition of the converted property occurred before January 1, 1951, and where the proceeds are received in a taxable year to which the Internal Revenue Code of 1954 applies. The term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) (1) Upon the involuntary conversion of property described in section 1033, no gain is recognized if the provisions of that section are complied with. If any part of the money received as a result of such an involuntary conversion is not expended in the manner provided in section 1033 (a) (2), the gain, if any, is recognized to the extent of the money which is not so expended. For example, a vessel purchased by A in 1949 for $100,000 is destroyed by a typhoon in 1950, and A receives in 1954 insurance in the amount of $100,000. This money is not expended in the manner provided in section 1033 (a) (2), but there is no gain since the insurance does not exceed the basis (disregarding, for the purposes of this example, the adjustment for depreciation). In 1955, A receives insurance from a second policy of $200,000 on account of the destruction of the vessel. He expends this amount in the manner provided in section 1033 (a) (2). The gain in 1955 upon the receipt of the $200,000 is recognized to the extent of $100,000, the amount of the money received in 1954 which was not expended in the manner provided in section 1033 (a) (2).

(2) Losses from involuntary conversions are recognized or not recognized without regard to section 1033. The expenditure in the manner provided in section 1033 (a) (2) of money received upon an involuntary conversion is not necessary for the transaction to be considered completed for the purpose of determining such loss.

(c) In order to avail himself of the benefits of section 1033 (a) (2) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The

benefits of section 1033 (a) (2) cannot be extended to a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

(d) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. If, in a condemnation proceeding, the Government makes an award to a mortgagee to satisfy a mortgage on the condemned property, the amount of such award shall be considered as part of the "money" into which the property is converted, regardless of whether or not the taxpayer was personally liable for the mortgage debt. Thus, if a taxpayer has acquired property worth $100,000 subject to a $50,000 mortgage (regardless of whether or not he was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer $60,000 and awards the mortgagee $50,000 in satisfaction of the mortgage, the entire $110,000 is considered to be the "money" into which the property was converted. An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

(e) The provisions of section 1033 (a) (2) are applicable to property used for residential or farming purposes.

(f) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(g) There is no investment in property similar in character and devoted to a similar use if—

(1) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(2) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(3) The owner of a requisitioned tug uses the proceeds to buy barges.

(h) It is incumbent upon a taxpayer "forthwith" to apply for and receive permission to establish a replacement fund in every case where it is not possible to replace immediately. If an expenditure in actual replacement would be too late, a request for the establishment of a replacement fund would likewise be too late.

§ 1.1033(a)–4 Replacement funds where disposition of the converted property occurred before January 1, 1951.

(a) This section applies only with respect to involuntary conversions where the disposition of the converted property (as defined in § 1.1033 (a)–3) occurred before January 1, 1951, and where the proceeds are received in a taxable year to which the Internal Revenue Code of 1954 applies.

(b) In any case where the taxpayer elects to replace or restore the converted property but it is not practicable to do so immediately (for example, because of a shortage of materials or an industry-wide strike), he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application on Form 1114 to the district director for the internal revenue district in which his return is required to be filed for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the district director may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. See 6 U.S.C. 15, providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. The estimated additional taxes, for the amount of which the applicant is required to furnish security, should be computed at the rates at which the applicant would have been obliged to pay, taking into consideration the remainder of his taxable (or net) income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the district director, the applicant, and the surety or depositary may each have a copy.

§ 1.1033(b) Statutory provisions; involuntary conversions; residence of taxpayer.

SEC. 1033. *Involuntary conversions.* * * *

(b) *Residence of taxpayer.* Subsection (a) shall not apply, in the case of property used by the taxpayer as his principal residence, if the destruction, theft, seizure, requisition, or condemnation of the residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954.

§ 1.1033(b)–1 Involuntary conversion of principal residence.

Section 1033 shall apply in the case of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurs before January 1, 1951, or after December 31, 1953. However, section 1033 shall not apply to the seizure, requisition, or condemnation (but not destruction), or the sale or exchange under threat or imminence thereof, of such residence property if the seizure, requisition, condemnation, sale, or exchange occurs after December 31, 1957, and if the taxpayer properly elects under section 1034 (i) (2) to treat the transaction as a sale (see paragraph (h) (2) (ii) of § 1.1034–1). Section 1033 shall not apply in the case of an involuntary conversion of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954. In the case of property disposed of after December 31, 1950, and before January 1, 1954, which is used by the taxpayer partially as a principal residence and partially for other purposes, proper allocation shall be made and § 1.1033(a)–2 and § 1.1033(c)–1 shall apply only with respect to the involuntary conversion of the portion used for such other purposes.

§ 1.1033(c) Statutory provisions; involuntary conversions; basis of property acquired through involuntary conversion.

SEC. 1033. *Involuntary conversions.* * * *

(c) *Basis of property acquired through involuntary conversion.* If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in subsection (a) (1) or (2), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made. This subsection shall not apply in respect of property acquired as a result of a compulsory or involuntary conversion of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence under threat or imminence thereof, occurred after December 31, 1950, and before January 1, 1954. In the case of property purchased by the taxpayer in a transaction described in subsection (a) (3) which resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.

§ 1.1033(c)–1 Basis of property acquired as a result of an involuntary conversion.

(a) The provisions of the first sentence of section 1033(c) may be illustrated by the following example:

Example. A's vessel which has an adjusted basis of $100,000 is destroyed in 1950 and A receives in 1951 insurance in the amount of $200,000. If A invests $150,000 in a new vessel, taxable gain to the extent of $50,000

would be recognized. The basis of the new vessel is $100,000; that is, the adjusted basis of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

(b) The provisions of the last sentence of section 1033 (c) may be illustrated by the following example:

Example. A taxpayer realizes $22,000 from the involuntary conversion of his barn in 1955; the adjusted basis of the barn to him was $10,000, and he spent in the same year $20,000 for a new barn which resulted in the nonrecognition of $10,000 of the $12,000 gain on the conversion. The basis of the new barn to the taxpayer would be $10,000—the cost of the new barn ($20,000) less the amount of the gain not recognized on the conversion ($10,000). The basis of the new barn would not be a substituted basis in the hands of the taxpayer within the meaning of section 1016 (b) (2). If the replacement of the converted barn had been made by the purchase of two smaller barns which, together, were similar or related in service or use to the converted barn and which cost $8,000 and $12,000, respectively, then the basis of the two barns would be $4,000 and $6,000, respectively, the total basis of the purchased property ($10,000) allocated in proportion to their respective costs (8,000/20,000 of $10,000 or $4,000; and 12,000/20,000 of $10,000, or $6,000).

§ 1.1033(d) Statutory provisions; involuntary conversions; property sold pursuant to reclamation laws.

SEC. 1033. *Involuntary conversions.* • • •

(d) *Property sold pursuant to reclamation laws.* For purposes of this subtitle, if property lying within an irrigation project is sold or otherwise disposed of in order to conform to the acreage limitation provisions of Federal reclamation laws, such sale or disposition shall be treated as an involuntary conversion to which this section applies.

§ 1.1033(d)–1 Disposition of excess property within irrigation project deemed to be involuntary conversion.

(a) The sale, exchange, or other disposition occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of excess lands lying within an irrigation project or division in order to conform to acreage limitations of the Federal reclamation laws effective with respect to such project or division shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. The term "excess lands" means irrigable lands within an irrigation project or division held by one owner in excess of the amount of irrigable land held by such owner entitled to receive water under the Federal reclamation laws applicable to such owner in such project or division. Such excess lands may be either (1) lands receiving no water from the project or division, or (2) lands receiving water only because the owner thereof has executed a valid recordable contract agreeing to sell such lands under terms and conditions satisfactory to the Secretary of the Interior.

(b) If a disposition in order to conform to the acreage limitation provisions of Federal reclamation laws includes property other than excess lands (as, for example, where the excess lands alone do not constitute a marketable parcel) the provisions of section 1033 (d) shall apply only to the part of the disposition that relates to excess lands.

(c) The provisions of § 1.1033 (a)–2 shall be applicable in the case of dispositions treated as involuntary conversions under this section. The details in connection with such a disposition required to be reported under paragraph (c) (2) of § 1.1033 (a)–2 shall include the authority whereby the lands disposed of are considered "excess lands", as defined in this section, and a statement that such disposition is not part of a plan contemplating the disposition of all or any nonexcess land within the irrigation project or division.

(d) The term "involuntary conversion", where it appears in subtitle A of the Code or the regulations thereunder, includes dispositions of excess property within irrigation projects described in this section. (See, e. g., section 1231 and the regulations thereunder.)

§ 1.1033(e) Statutory provisions; involuntary conversions; livestock destroyed by disease.

SEC. 1033. *Involuntary conversions.* • • •

(e) *Livestock destroyed by disease.* For purposes of this subtitle, if livestock are destroyed by or on account of disease, or are sold or exchanged because of disease, such destruction or such sale or exchange shall be treated as an involuntary conversion to which this section applies.

§ 1.1033(e)–1 Destruction or disposition of livestock because of disease.

(a) The destruction occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of livestock by, or on account of, disease, or the sale or exchange, in such a year, of livestock because of disease, shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. Livestock which are killed either because they are diseased or because of exposure to disease shall be considered destroyed on account of disease. Livestock which are sold or exchanged because they are diseased or have been exposed to disease, and would not otherwise have been sold or exchanged at that particular time shall be considered sold or exchanged because of disease.

(b) The provisions of § 1.1033 (a)–2 shall be applicable in the case of a disposition treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c) (2) of § 1.1033 (a)–2 shall include a recital of the evidence that the livestock were destroyed by or on account of disease, or sold or exchanged because of disease.

(c) The term "involuntary conversion," where it appears in subtitle A of the Code or the regulations thereunder, includes disposition of livestock described in this section. (See, e. g., section 1231 and the regulations thereunder.)

§ 1.1033(f) Statutory provisions; livestock sold on account of drought.

SEC. 1033. *Involuntary conversion.* • • •

(f) *Livestock sold on account of drought.* For purposes of this subtitle, the sale or exchange of livestock (other than poultry) held by a taxpayer for draft, breeding, or dairy purposes in excess of the number the taxpayer would sell if he followed his usual business practices shall be treated as an involuntary conversion to which this section applies if such livestock are sold or exchanged by the taxpayer solely on account of drought.

[Sec. 1033 (f) as added by sec. 5, Act of June 29, 1956 (Pub. Law 629, 84th Cong., 70 Stat. 40]

§ 1.1033(f)–1 Sale or exchange of livestock solely on account of drought.

(a) The sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes in excess of the number the taxpayer would sell or exchange during the taxable year if he followed his usual business practices shall be treated as an involuntary conversion to which section 1033 and the regulations thereunder are applicable if the sale or exchange of such livestock by the taxpayer is solely on account of drought. Section 1033 (f) and this section shall apply only to sales and exchanges occurring after December 31, 1955.

(b) To qualify under section 1033 (f) and this section, the sale or exchange of the livestock need not take place in a drought area. While it is not necessary that the livestock be held in a drought area, the sale or exchange of the livestock must be solely on account of drought conditions the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale or exchange.

(c) The total sales or exchanges of livestock held for draft, breeding, or dairy purposes occurring in any taxable year which may qualify as an involuntary conversion under section 1033 (f) and this section is limited to the excess of the total number of such livestock sold or exchanged during the taxable year over the number that the taxpayer would have sold or exchanged if he had followed his usual business practices, that is, the number he would have been expected to sell or exchange under ordinary circumstances if there had been no drought. For example, if in the past it has been a taxpayer's practice to sell or exchange annually one-half of his herd of dairy cows, only the number sold or exchanged solely on account of drought conditions which is in excess of one-half of his herd, may qualify as an involuntary conversion under section 1033(f) and this section.

(d) The replacement requirements of section 1033 will be satisfied only if the livestock sold or exchanged is replaced within the prescribed period with livestock which is similar or related in service or use to the livestock sold or exchanged because of drought, that is, the new livestock must be functionally the same as the livestock involuntarily converted. This means that the new livestock must be held for the same useful purpose as the old was held. Thus, although dairy cows could be replaced by

dairy cows, a taxpayer could not replace draft animals with breeding or dairy animals.

(e) The provisions of § 1.1033 (a)–2 shall be applicable in the case of a sale or exchange treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c) (2) of § 1.1033 (a)–2 shall include:

(1) Evidence of the existence of the drought conditions which forced the sale or exchange of the livestock;

(2) A computation of the amount of gain realized on the sale or exchange;

(3) The number and kind of livestock sold or exchanged; and

(4) The number of livestock of each kind that would have been sold or exchanged under the usual business practice in the absence of the drought.

(f) The term "involuntary conversion", where it appears in subtitle A of the Code or the regulations thereunder, includes the sale or exchange of livestock described in this section.

(g) The provisions of section 1033 (f) and this section apply to taxable years ending after December 31, 1955, but only in the case of sales or exchange of livestock after December 31, 1955.

§ 1.1033(g) Statutory provisions; involuntary conversions; condemnation of real property held for productive use in trade or business or for investment.

SEC. 1033. *Involuntary conversions.* * * *

(g) *Condemnation of real property held for productive use in trade or business or for investment*—(1) *Special rule.* For purposes of subsection (a), if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted.

(2) *Limitations*—(A) *Purchase of stock.* Paragraph (1) shall not apply to the purchase of stock in the acquisition of control of a corporation described in subsection (a) (3) (A).

(B) *Conversions before January 1, 1958.* Paragraph (1) shall apply with respect to the compulsory or involuntary conversion of any real property only if the disposition of the converted property (within the meaning of subsection (a) (2)) occurs after December 31, 1957.

[Sec. 1033(g) as added by sec. 46(a), Technical Amendments Act 1958 (72 Stat. 1641)]

§ 1.1033(g)–1 Condemnation of real property held for productive use in trade or business or for investment.

(a) *Special rule in general.* This section provides special rules for applying section 1033 with respect to certain dispositions, occurring after December 31, 1957, of real property held either for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale). For this purpose, disposition means the seizure, requisition, or condemnation (but not destruction) of the converted property, or the sale or exchange of such property under threat or imminence of seizure, requisition, or condemnation. In such cases, for purposes of applying section 1033, the replacement of such property with property of like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. For principles in determining whether the replacement property is property of like kind, see paragraph (b) of § 1.1031(a)–1.

(b) *Limitation on application of special rule.* This section shall not apply to the purchase of stock in the acquisition of control of a corporation described in section 1033(a)(3)(A).

§ 1.1033(h) Statutory provisions; involuntary conversions; cross references.

SEC. 1033. *Involuntary conversions.* * * *

(h) *Cross references.* (1) For determination of the period for which the taxpayer has held property involuntarily converted, see section 1223.

(2) For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231 (a).

[Sec. 1033(h) as amended by sec. 46(a), Technical Amendments Act 1958 (72 Stat. 1641)]

§ 1.1033(h)–1 Effective date.

Except as provided otherwise in § 1.1033(f)–1 and § 1.1033(g)–1, the provisions of section 1033 and the regulations thereunder are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954.

§ 1.1034 Statutory provisions; sale or exchange of residence.

SEC. 1034. *Sale or exchange of residence*—(a) *Nonrecognition of gain.* If property (in this section called "old residence") used by the taxpayer as his principal residence is sold by him after December 31, 1953, and, within a period beginning 1 year before the date of such sale and ending 1 year after such date, property (in this section called "new residence") is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price (as defined in subsection (b)) of the old residence exceeds the taxpayer's cost of purchasing the new residence.

(b) *Adjusted sale price defined*—(1) *In general.* For purposes of this section, the term "adjusted sales price" means the amount realized, reduced by the aggregate of the expenses for work performed on the old residence in order to assist in its sale.

(2) *Limitations.* The reduction provided in paragraph (1) applies only to expenses—

(A) For work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into;

(B) Which are paid on or before the 30th day after the date of the sale of the old residence; and

(C) Which are—

(i) Not allowable as deductions in computing taxable income under section 63 (a) (defining taxable income), and

(ii) Not taken into account in computing the amount realized from the sale of the old residence.

(3) *Effective date.* The reduction provided in paragraph (1) applies to expenses for work performed in any taxable year (whether beginning before, on, or after January 1, 1954), but only in the case of a sale or exchange of an old residence which occurs after December 31, 1953.

(c) *Rules for application of section.* For purposes of this section:

(1) An exchange by the taxpayer of his residence for other property shall be treated as a sale of such residence, and the acquisition of a residence on the exchange of property shall be treated as a purchase of such residence.

(2) A residence any part of which was constructed or reconstructed by the taxpayer shall be treated as purchased by the taxpayer. In determining the taxpayer's cost of purchasing a residence, there shall be included only so much of his cost as is attributable to the acquisition, construction, reconstruction, and improvements made which are properly chargeable to capital account, during the period specified in subsection (a).

(3) If a residence is purchased by the taxpayer before the date of his sale of the old residence, the purchased residence shall not be treated as his new residence if sold or otherwise disposed of by him before the date of the sale of the old residence.

(4) If the taxpayer, during the period described in subsection (a), purchases more than one residence which is used by him as his principal residence at some time within 1 year after the date of the sale of the old residence, only the last of such residences so used by him after the date of such sale shall constitute the new residence.

(5) In the case of a new residence the construction of which was commenced by the taxpayer before the expiration of one year after the date of the sale of the old residence, the period specified in subsection (a), and the 1 year referred to in paragraph (4) of this subsection, shall be treated as including a period of 18 months beginning with the date of the sale of the old residence.

(d) *Limitation.* Subsection (a) shall not apply with respect to the sale of the taxpayer's residence if within 1 year before the date of such sale the taxpayer sold at a gain other property used by him as his principal residence, and any part of such gain was not recognized by reason of subsection (a) or section 112 (n) of the Internal Revenue Code of 1939.

(e) *Basis of new residence.* Where the purchase of a new residence results, under subsection (a) or under section 112 (n) of the Internal Revenue Code of 1939, in the nonrecognition of gain on the sale of an old residence, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain not so recognized on the sale of the old residence. For this purpose, the amount of the gain not so recognized on the sale of the old residence includes only so much of such gain as is not recognized by reason of the cost, up to such time, of purchasing the new residence.

(f) *Tenant-stockholder in a cooperative housing corporation.* For purposes of this section, section 1016 (relating to adjustments to basis), and section 1223 (relating to holding period), references to property used by the taxpayer as his principal residence, and references to the residence of a taxpayer, shall include stock held by a tenant-stockholder (as defined in section 216, relating to deduction for amounts representing taxes and interest paid to a cooperative housing corporation) in a cooperative housing corporation (as defined in such section) if—

(1) In the case of stock sold, the house or apartment which the taxpayer was entitled to occupy as such stockholder was used by him as his principal residence, and

(2) In the case of stock purchased, the taxpayer used as his principal residence the

house or apartment which he was entitled to occupy as such stockholder.

(g) *Husband and wife.* If the taxpayer and his spouse, in accordance with regulations which shall be prescribed by the Secretary or his delegate pursuant to this subsection, consent to the application of paragraph (2) of this subsection, then—

(1) For purposes of this section—

(A) The taxpayer's adjusted sales price of the old residence is the adjusted sales price (of the taxpayer, or of the taxpayer and his spouse) of the old residence, and

(B) The taxpayer's cost of purchasing the new residence is the cost (to the taxpayer, his spouse, or both) of purchasing the new residence (whether held by the taxpayer, his spouse, or the taxpayer and his spouse); and

(2) So much of the gain on the sale of the old residence as is not recognized solely by reason of this subsection, and so much of the adjustment under subsection (e) to the basis of the new residence as results solely from this subsection shall be allocated between the taxpayer and his spouse as provided in such regulations.

This subsection shall apply only if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence. In case the taxpayer and his spouse do not consent to the application of paragraph (2) of this subsection then the recognition of gain on the sale of the old residence shall be determined under this section without regard to the rules provided in this subsection.

(h) *Members of Armed Forces.* The running of any period of time specified in subsection (a) or (c) (other than the 1 year referred to in subsection (c) (4)) shall be suspended during any time that the taxpayer (or his spouse if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence) serves on extended active duty with the Armed Forces of the United States after the date of the sale of the old residence and during an induction period (as defined in section 112 (c) (5)) except that any such period of time as so suspended shall not extend beyond the date 4 years after the date of the sale of the old residence. For purposes of this subsection, the term "extended active duty" means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

(i) *Special rule for involuntary conversions*—(1) *In general.* For purposes of this section, the destruction, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof—

(A) If occurring after December 31, 1950, and before January 1, 1954, shall be treated as the sale of such property; and

(B) If occurring after December 31, 1953, shall not be treated as the sale of such property.

(2) *Condemnations after December 31, 1957.* For purposes of this section, the seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof, if occurring after December 31, 1957, shall, at the election of the taxpayer, be treated as the sale of such property. Such election shall be made at such time and in such manner as the Secretary or his delegate shall prescribe by regulations.

(3) *Cross reference.* For treatment of residences involuntarily converted after December 31, 1953, see section 1033 (relating to involuntary conversions).

(j) *Statute of limitations.* If after December 31, 1950, the taxpayer during a taxable year sells at a gain property used by him as his principal residence, then—

(1) The statutory period for the assessment of any deficiency attributable to any part of such gain shall not expire before the expiration of 3 years from the date the Secretary or his delegate is notified by the taxpayer (in such manner as the Secretary or his delegate may by regulations prescribe) of—

(A) The taxpayer's cost of purchasing the new residence which the taxpayer claims results in nonrecognition of any part of such gain,

(B) The taxpayer's intention not to purchase a new residence within the period specified in subsection (a), or

(C) A failure to make such purchase within such period; and

(2) Such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

[Sec. 1034 as amended by sec. 46(b), Technical Amendments Act 1958 (72 Stat. 1642)]

§ 1.1034–1 Sale or exchange of residence.

(a) *Nonrecognition of gain; general statement.* Section 1034 provides rules for the nonrecognition of gain in certain cases where a taxpayer sells one residence after December 31, 1953, and buys or builds, and uses as his principal residence, another residence within specified time limits before or after such sale. In general, if the taxpayer invests in a new residence an amount at least as large as the adjusted sales price of his old residence, no gain is recognized on the sale of the old residence (see paragraph (b) of this section for definitions of "adjusted sales price", "new residence", and "old residence"). On the other hand, if the new residence costs the taxpayer less than the adjusted sales price of the old residence, gain is recognized to the extent of the difference. Thus, if an amount equal to or greater than the adjusted sales price of an old residence is invested in a new residence, according to the rules stated in section 1034, none of the gain (if any) realized from the sale shall be recognized. If an amount less than such adjusted sales price is so invested, gain shall be recognized, but only to the extent provided in section 1034. If there is no investment in a new residence, section 1034 is inapplicable and all of the gain shall be recognized. Whenever, as a result of the application of section 1034, any or all of the gain realized on the sale of an old residence is not recognized, a corresponding reduction must be made in the basis of the new residence. The provisions of section 1034 are mandatory, so that the taxpayer cannot elect to have gain recognized under circumstances where this section is applicable. Section 1034 applies only to gains; losses are recognized or not recognized without regard to the provisions of this section. Section 1034 affects only the amount of gain recognized, and not the amount of gain realized (see also section 1001 and regulations issued thereunder). Any gain realized upon disposition of other property in exchange for the new residence is not affected by section 1034.

(b) *Definitions.* The following definitions of frequently used terms are applicable for purposes of section 1034 (other definitions and detailed explanations appear in subsequent paragraphs of this regulation):

(1) "Old residence" means property used by the taxpayer as his principal residence which is the subject of a sale by him after December 31, 1953 (section 1034 (a); for detailed explanation see paragraph (c) (3) of this section).

(2) "New residence" means property used by the taxpayer as his principal residence which is the subject of a purchase by him (section 1034 (a); for detailed explanation and limitations see paragraph (c) (3) and (d) (1) of this section).

(3) "Adjusted sales price" means the amount realized reduced by the fixing-up expenses (section 1034 (b) (1); for special rule applicable in some cases to husband and wife, see paragraph (f) of this section).

(4) "Amount realized" is to be computed by subtracting

(i) The amount of the items which, in determining the gain from the sale of the old residence, are properly an offset against the consideration received upon the sale (such as commissions and expenses of advertising the property for sale, of preparing the deed, and of other legal services in connection with the sale); from

(ii) The amount of the consideration so received, determined (in accordance with section 1001 (b) and regulations issued thereunder) by adding to the sum of any money so received, the fair market value of the property (other than money) so received. If, as part of the consideration for the sale, the purchaser either assumes a liability of the taxpayer or acquires the old residence subject to a liability (whether or not the taxpayer is personally liable on the debt), such assumption or acquisition, in the amount of the liability, shall be treated as money received by the taxpayer in computing the "amount realized."

(5) "Gain realized" is the excess (if any) of the amount realized over the adjusted basis of the old residence (see also section 1001 (a) and regulations issued thereunder).

(6) "Fixing-up expenses" means the aggregate of the expenses for work performed (in any taxable year, whether beginning before, on, or after January 1, 1954) on the old residence in order to assist in its sale, provided that such expenses (i) are incurred for work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into; and (ii) are paid on or before the 30th day after the date of the sale of the old residence; and (iii) are neither (*a*) allowable as deductions in computing taxable income under section 63 (a), nor (*b*) taken into account in computing the amount realized from the sale of the old residence (section 1034 (b) (2) and (3)). "Fixing-up expenses" does not include expenditures which are properly chargeable to capital account and which would, therefore, constitute adjustments to the basis of the old residence (see section 1016 and regulations issued thereunder).

(7) "Cost of purchasing the new residence" means the total of all amounts which are attributable to the acquisition, construction, reconstruction, and

improvements constituting capital expenditures, made during the period beginning one year before the date of sale of the old residence and ending either (i) one year after such date in the case of a new residence purchased but not constructed by the taxpayer, or (ii) 18 months after such date in the case of a new residence the construction of which was commenced by the taxpayer before the expiration of one year after such date (section 1034 (a), (c) (2) and (c) (5); for detailed explanation, see paragraph (c) (4) of this section; for special rule applicable in some cases to husband and wife, see paragraph (f) of this section; see also paragraph (b) (9) of this section for definition of "purchase").

(8) "Sale" (of a residence) means a sale or an exchange (of a residence) for other property which occurs after December 31, 1953, an involuntary conversion (of a residence) which occurs after December 31, 1950, and before January 1, 1954, or certain involuntary conversions where the disposition of the property occurs after December 31, 1957, in respect of which a proper election is made under section 1034(i)(2) (see sections 1034(c)(1), 1034(i)(1)(A), and 1034(i)(2); for detailed explanation concerning involuntary conversions, see paragraph (h) of this section).

(9) "Purchase" (of a residence) means a purchase or an acquisition (of a residence) on the exchange of property or the partial or total construction or reconstruction (of a residence) by the taxpayer (section 1034 (c)(1) and (2)). However, the mere improvement of a residence, not amounting to reconstruction, does not constitute "purchase" of a residence.

(c) *Rules for application of section 1034*—(1) *General rule; limitations on applicability.* Gain realized from the sale (after December 31, 1953) of an old residence will be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence, provided that the taxpayer either (i) within a period beginning one year before the date of such sale and ending one year after such date purchases property and uses it as his principal residence, or (ii) within a period beginning one year before the date of such sale and ending 18 months after such date uses as his principal residence a new residence the construction of which was commenced by him at any time before the expiration of one year after the date of the sale of the old residence (section 1034 (a) and (c) (5); for detailed explanation of use as "principal residence" see subparagraph (3) of this paragraph). The rule stated in the preceding sentence applies to a new residence purchased by the taxpayer before the date of sale of the old residence provided the new residence is still owned by him on such date (section 1034 (c) (3)). Whether the construction of a new residence was commenced by the taxpayer before the expiration of one year after the date of the sale of the old residence will depend upon the facts and circumstances of each case. Section 1034 is not applicable to the sale of a residence if within the previous year the taxpayer made another sale of residential property on which gain was realized but not recognized (section 1034 (d)). For further details concerning limitations on the application of section 1034, see paragraph (d) of this section.

(2) *Computation and examples.* In applying the general rule stated in subparagraph (1) of this paragraph, the taxpayer should first subtract the commissions and other selling expenses from the selling price of his old residence, to determine the amount realized. A comparison of the amount realized with the cost or other basis of the old residence will then indicate whether there is any gain realized or the sale. Unless the amount realized is greater than the cost or other basis, no gain is realized and section 1034 does not apply. If the amount realized exceeds the cost or other basis, the amount of such excess constitutes the gain realized. The amount realized should then be reduced by the fixing-up expenses (if any), to determine the adjusted sales price. A comparison of the adjusted sales price of the old residence with the cost of purchasing the new residence will indicate how much (if any) of the realized gain is to be recognized. If the cost of purchasing the new residence is the same as, or greater than, the adjusted sales price of the old residence, then none of the realized gain is to be recognized. On the other hand, if the cost of purchasing the new residence is smaller than the adjusted sales price of the old residence, the gain realized is to be recognized to the extent of the difference. (It should be noted that any amount of gain realized but not recognized is to be applied as a downward adjustment to the basis of the new residence (for details see paragraph (e) of this section).) The application of the general rule stated above may be illustrated by the following examples:

Example (1). A taxpayer decides to sell his residence, which has a basis of $17,500. To make it more attractive to buyers, he paints the outside at a cost of $300 in April, 1954. He pays for the painting when the work is finished. In May, 1954, he sells the house for $20,000. Brokers' commissions and other selling expenses are $1,000. In October, 1954, the taxpayer buys a new residence for $18,000. The amount realized, the gain realized, the adjusted sales price, and the gain to be recognized are computed as follows:

Selling price	$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	$19,000
Less: Fixing-up expenses	300
Adjusted sales price	18,700
Cost of purchasing new residence	18,000
Gain recognized	700
Gain realized but not recognized	800
Adjusted basis of new residence (see paragraph (e) of this section)	$17,200

Example (2). The facts are the same as in example (1), except that the selling price of the old residence is $18,500. The computations are as follows:

Selling price	$18,500
Less: Commissions and other selling expenses	1,000
Amount realized	17,500
Less: Basis	17,500
Gain realized	0

NOTE: Since no gain is realized, section 1034 is inapplicable; it is, therefore, unnecessary to compute the adjusted sales price of the old residence and compare it with the cost of purchasing the new residence. No adjustment to the basis of the new residence is to be made.

Example (3). The facts are the same as in example (1), except that the cost of purchasing the new residence is $17,000. The computations are as follows:

Selling price	$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	$19,000
Less: Fixing-up expenses	300
Adjusted sales price	18,700
Cost of purchasing the new residence	17,000
Gain recognized	1,500

NOTE: Since the adjusted sales price of the old residence exceeds the cost of purchasing the new residence by $1,700, which is more than the gain realized, all of the gain realized is recognized. No adjustment to the basis of the new residence is to be made.

Gain realized but not recognized	$0

Example (4). The facts are the same as in example (1), except that the fixing-up expenses are $1,100. The computations are as follows:

Selling price	$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	$19,000
Less: Fixing-up expenses	1,100
Adjusted sales price	17,900
Cost of purchasing the new residence	18,000
Gain recognized	0

NOTE: Since the cost of purchasing the new residence exceeds the adjusted sales price, none of the gain realized is recognized.

Gain realized but not recognized	$1,500
Adjusted basis of new residence (see paragraph (e) of this section)	16,500

(3) *Property used by the taxpayer as his principal residence.* (i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case, including

the good faith of the taxpayer. The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he temporarily rents out the new residence during the period before he vacates the old residence may not, in the light of all the facts and circumstances in the case, prevent the new residence from being considered as property used by the taxpayer as his principal residence. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216 (b), (1) and (2)), if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his principal residence (section 1034 (f)). Property used by the taxpayer as his principal residence does not include personal property such as a piece of furniture, a radio, etc., which, in accordance with the applicable local law, is not a fixture.

(ii) Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this section. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under this section and only an amount allocable to the selling price of such portion need be invested in the new residence in order to have the gain allocable to such portion not recognized under this section. If the new residence is used only partially for residential purposes only so much of its cost as is allocable to the residential portion may be counted as the cost of purchasing the new residence.

(4) *Cost of purchasing new residence.* (i) The taxpayer's cost of purchasing the new residence includes not only cash but also any indebtedness to which the property purchased is subject at the time of purchase whether or not assumed by the taxpayer (including purchase-money mortgages, etc.) and the face amount of any liabilities of the taxpayer which are part of the consideration for the purchase. Commissions and other purchasing expenses paid or incurred by the taxpayer on the purchase of the new residence are to be included in determining such cost. In the case of an acquisition of a residence upon an exchange which is considered as a "purchase" under this section, the fair market value of the new residence on the date of the exchange shall be considered as the taxpayer's cost of purchasing the new residence. Where any part of the new residence is acquired by the taxpayer other than by "purchase", the value of such part is not to be included in determining the taxpayer's cost of the new residence (see paragraph (b) (9) of this section for definition of "purchase"). For example, if the taxpayer acquires a residence by gift or inheritance, and spends $20,000 in reconstructing such residence, only such $20,000 may be treated as his cost of purchasing the new residence.

(ii) The taxpayer's cost of purchasing the new residence includes only so much of such cost as is attributable to acquisition, construction, reconstruction, or improvements made within the 2-year or 30-month period of time, as the case may be, in which the purchase and use of the new residence must be made in order to have gain on the sale of the old residence not recognized under this section. Thus, if the construction of the new residence is begun two years before the date of sale of the old residence and completed on the date of sale of the old residence, only that portion of the cost which is attributable to the second year of such construction constitutes the taxpayer's cost of purchasing the new residence, for purposes of section 1034. Furthermore, the taxpayer's cost of purchasing the new residence includes only such amounts as are properly chargeable to capital account rather than to current expense. As to what constitutes capital expenditures, see section 263.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. M began the construction of a new residence on January 15, 1955, and completed it on October 14, 1955. The cost of $18,000 was incurred ratably over the 9-month period of construction. On July 14, 1956, M sold his old residence and realized a gain of $7,200. In determining the extent to which the realized gain is not to be recognized under section 1034, M's cost of constructing the new residence shall include only the $6,000 which was attributable to the July 15–October 14, 1955, period (3 months at $2,000). The $12,000 balance of the cost of constructing the new residence was not attributable to the period beginning one year before the date of sale of the old residence and ending 18 months after such date and, under section 1034, is not properly a part of M's cost of constructing the new residence.

(d) *Limitations on application of section 1034.* (1) If a residence is purchased by the taxpayer prior to the date of the sale of the old residence, the purchased residence shall, in no event, be treated as a new residence if such purchased residence is sold or otherwise disposed of by him prior to the date of the sale of the old residence (section 1034 (c) (3)). And, if the taxpayer, during the period within which the purchase and use of the new residence must be made in order to have any gain on the sale of the old residence not recognized under this section, purchases more than one property which is used by him as his principal residence during the one year (or 18 months in the case of the construction of the new residence) succeeding the date of the sale of the old residence, only the last of such properties shall be considered a new residence (section 1034 (c) (4)). If within one year before the date of the sale of the old residence, the taxpayer sold other property used by him as his principal residence at a gain, and any part of such gain was not recognized under this section or section 112 (n) of the Internal Revenue Code of 1939, this section shall not apply with respect to the sale of the old residence (section 1034 (d)).

(2) The following example will illustrate the rules of subparagraph (1) of this paragraph:

Example. A taxpayer sells his old residence on January 15, 1954, and purchases another residence on February 15, 1954. On March 15, 1954, he sells the residence which he bought on February 15, 1954, and purchases another residence on April 15, 1954. The gain on the sale of the old residence on January 15, 1954, will not be recognized except to the extent to which the taxpayer's adjusted sales price of the old residence exceeds the cost of purchasing the residence which he purchased on April 15, 1954. Gain on the sale of the residence which was bought on February 15, 1954, and sold on March 15, 1954, will be recognized.

(e) *Basis of new residence.* (1) Where the purchase of a new residence results, under this section, in the nonrecognition of any part of the gain realized upon the sale of an old residence, then, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain which was not recognized upon the sale of the old residence (section 1034 (e); for special rule applicable in some cases to husband and wife, see paragraph (f) of this section). Such a reduction is not to be made for the purpose of determining the adjusted basis of the new residence as of any time preceding the sale of the old residence. For the purpose of this determination, the amount of the gain not recognized under this section upon the sale of the old residence includes only so much of the gain as is not recognized because of the taxpayer's cost, up to the date of the determination of the adjusted basis, of purchasing the new residence.

(2) The following example will illustrate the rule of subparagraph (1) of this paragraph:

Example. On January 1, 1954, the taxpayer buys a new residence for $10,000. On March 1, 1954, he sells for an adjusted sales price of $15,000 his old residence, which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $15,000 is the "amount realized" as well as the "adjusted sales price"). Between April 1 and April 15 a wing is constructed on the new house at a cost of $5,000. Between May 1 and May 15 a garage is constructed at a cost of $2,000. The adjusted basis of the new residence is $10,000 during January and February, $5,000 during March, $5,000 following the completion of the construction in April, and $7,000 following the completion of the construction in May. Since the old residence was not sold until March 1, no adjustment to the basis of the new residence is made during January and February. Computations for March, April, and May are as follows:

Amount realized on sale of old residence	$15,000
Less: Adjusted basis of old residence	5,000
Gain realized on sale of old residence	10,000

March 1, 1954

Adjusted sales price of old residence	$15,000
Less: Cost of purchasing new residence	10,000
Gain recognized	5,000

Gain realized but not recognized	$5,000
Cost of purchasing new residence	$10,000
Less: Gain realized but not recognized	5,000
Adjusted basis of new residence	5,000

April 15, 1954

Gain realized on sale of old residence	$10,000
Adjusted sales price of old residence	15,000
Less: Cost of purchasing new residence	15,000
Gain recognized	0
Gain realized but not recognized	10,000
Cost of purchasing new residence	$15,000
Less: Gain realized but not recognized	10,000
Adjusted basis of new residence	5,000

May 15, 1954

Gain realized on sale of old residence	$10,000
Adjusted sales price of old residence	15,000
Less: Cost of purchasing new residence	17,000
Gain recognized	0
Gain realized but not recognized	10,000
Cost of purchasing new residence	$17,000
Less: Gain realized but not recognized	10,000
Adjusted basis of new residence	7,000

(f) *Husband and wife.* (1) If the taxpayer and his spouse file the consent referred to in this paragraph, then the "taxpayer's adjusted sales price of the old residence" shall mean the taxpayer's, or the taxpayer's and his spouse's, adjusted sales price of the old residence, and the "taxpayer's cost of purchasing the new residence" shall mean the cost to the taxpayer, or to his spouse, or to both of them, of purchasing the new residence, whether such new residence is held by the taxpayer, or his spouse, or both (section 1034 (g)). Such consent may be filed only if the old residence and the new residence are each used by the taxpayer and his same spouse as their principal residence. If the taxpayer and his spouse do not file such a consent, the recognition of gain upon sale of the old residence shall be determined under this section without regard to the foregoing.

(2) The consent referred to in subparagraph (1) of this paragraph is a consent by the taxpayer and his spouse to have the basis of the interest of either of them in the new residence reduced from what it would have been but for the filing of such consent by an amount by which the gain of either of them on the sale of his interest in the old residence is not recognized solely by reason of the filing of such consent. Such reduction in basis is applicable to the basis of the new residence, whether such basis is that of the husband, of the wife, or divided between them. If the basis is divided between the husband and wife, the reduction in basis shall be divided between them in the same proportion as the basis (determined without regard to such reduction) is divided. Such consent shall be filed with the district director with whom the taxpayer filed the return for the taxable year or years in which the gain from the sale of the old residence was realized.

(3) The following examples will illustrate the application of this rule:

Example (1). A taxpayer, in 1954, sells for an adjusted sales price of $10,000 the principal residence of himself and his wife, which he owns individually and which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $10,000 is the "amount realized" as well as the "adjusted sales price"). Within a year after such sale he and his wife contribute $5,000 each from their separate funds for the purchase of their new principal residence which they hold as tenants in common, each owning an undivided one-half interest therein. If the taxpayer and his wife file the required consent, the gain of $5,000 upon the sale of the old residence will not be recognized to the taxpayer, and the adjusted basis of the taxpayer's interest in the new residence will be $2,500 and the adjusted basis of his wife's interest in such property will be $2,500.

Example (2). A taxpayer and his wife, in 1954, sell for an adjusted sales price of $10,000 their principal residence, which they own as joint tenants and which has an adjusted basis of $2,500 to each of them ($5,000 together) (no fixing-up expenses are involved, so that $10,000 is the "amount realized" as well as the "adjusted sales price"). Within a year after such sale, the wife spends $10,000 of her own funds in the purchase of a principal residence for herself and the taxpayer and takes title in her name only. If the taxpayer and his wife file the required consent, the adjusted basis to the wife of the new residence will be $5,000, and the gain of the taxpayer of $2,500 upon the sale of the old residence will not be recognized. The wife, as a taxpayer herself, will have her gain of $2,500 on the sale of the old residence not recognized under the general rule.

(g) *Members of Armed Forces.* (1) Section 1034 (h) provides a special rule for members of the Armed Forces with respect to the period after the sale of the old residence within which the acquisition of a new residence may result in a nonrecognition of gain on such sale. The running of the 1-year period after the sale of the old residence in the case of the purchase of a new residence, or the 18-month period after such sale in the case of the construction of a new residence, is suspended during any time that the taxpayer serves on extended active duty with the Armed Forces of the United States during an induction period (as defined in section 112 (c) (5)). However, in no event may such suspension extend for more than four years after the date of the sale of the old residence the period within which the purchase or construction of a new residence may result in a nonrecognition of gain. For example, if the taxpayer is on extended active duty with the Army from January 1, 1951, to December 31, 1953, and if he sold his old residence on January 1, 1951, the latest date on which the taxpayer may use a new residence constructed by him and have any part of the gain on the sale of the old residence not recognized under this section is January 1, 1955, the date four years after the date of sale of the old residence.

(2) This suspension covers not only the Armed Forces service of the taxpayer but if the taxpayer and his same spouse used both the old and the new residences as their principal residence, then the extension applies in like manner to the time the taxpayer's spouse is on extended active duty with the Armed Forces of the United States.

(3) The time during which the running of the period is suspended is part of such period. Thus, construction costs during such time are includible in the cost of purchasing the new residence under paragraph (c) (4) of this section.

(4) The running of the 1-year (or 18-month) period after the date of sale of the old residence referred to in section 1034 (c) (4) and in paragraph (d) of this section is not suspended; neither is the running of the 1-year period prior to the date of the sale of the old residence within which the new residence may be purchased in order to have gain on the sale of the old residence not recognized under this section.

(5) The term "extended active duty" means any period of active duty which is served pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. If the call or order is for a period of more than 90 days, it is immaterial that the time served pursuant to such call or order is less than 90 days if the reason for such shorter period of service occurs after the beginning of such duty. As to what constitutes active service as a member of the Armed Forces of the United States, see paragraph (i) of § 1.112–1. As to who are members of the Armed Forces of the United States, see section 7701 (a) (15), and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

(h) *Special rules for involuntary conversions*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, section 1034 is inapplicable to involuntary conversions of personal residences occurring after December 31, 1953 (section 1034(i)(1)(B)). For purposes of section 1034, an involuntary conversion of a personal residence occurring after December 31, 1950, and before January 1, 1954, is treated as a sale of such residence (section 1034(i)(1)(A); see paragraph (b)(8) of this section). For purposes of this paragraph, an involuntary conversion is defined as the destruction in whole or in part, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof. See section 1033 and § 1.1033 (b)–1 for treatment of residences involuntarily converted after December 31, 1953.

(2) *Election to treat condemnation of personal residence as sale.* (i) Section 1034(i)(2) provides a special rule which permits a taxpayer to elect to treat the seizure, requisition, or condemnation of his principal residence, or the sale or exchange of such residence under threat or imminence thereof, if occurring after December 31, 1957, as the sale of such residence for purposes of section 1034 (relating to sale or exchange of residence). A taxpayer may thus elect to have section 1034 apply, rather than section 1033 (relating to involuntary conversions), in determining the amount of

gain realized on the disposition of his old residence that will not be recognized and the extent to which the basis of his new residence acquired in lieu thereof shall be reduced. Once made, the election shall be irrevocable.

(ii) If the taxpayer elects to be governed by the provisions of section 1034, section 1033 will have no application. Thus, a taxpayer who elects under section 1034(i)(2) to treat the seizure, requisition, or condemnation of his principal residence (but not the destruction), or the sale or exchange of such residence under threat or imminence thereof as a sale for the purposes of section 1034, must satisfy the requirements of section 1034 and this section. For example, under section 1034 a taxpayer generally must replace his old residence with a new residence which he uses as his principal residence, within a period beginning one year before the date of disposition of his old residence, and ending one year after such date. However, in the case of a new residence the construction of which was commenced by the taxpayer within such period, the replacement period shall not expire until 18 months after the date of disposition of the old residence.

(iii) *Time and manner of making election.* The election under section 1034(i)(2) shall be made in a statement attached to the taxpayer's income tax return, when filed, for the taxable year during which the disposition of his old residence occurs. The statement shall indicate that the taxpayer elects under section 1034(i)(2) to treat the disposition of his old residence as a sale for purposes of section 1034, and shall also show—

(*a*) The basis of the old residence;

(*b*) The date of its disposition;

(*c*) The adjusted sales price of the old residence, if known; and

(*d*) The purchase price, date of purchase, and date of occupancy of the new residence if it has been acquired prior to the time of making the election.

(i) *Statute of limitations.* (1) Whenever a taxpayer sells property used as his principal residence at a gain, the statutory period prescribed in section 6501 (a) for the assessment of a deficiency attributable to any part of such gain shall not expire prior to the expiration of three years from the date of receipt, by the district director with whom the return was filed for the taxable year or years in which the gain from the sale of the old residence was realized (section 1034 (j)), of a written notice from the taxpayer of—

(i) The taxpayer's cost of purchasing the new residence which the taxpayer claims result in nonrecognition of any part of such gain,

(ii) The taxpayer's intention not to purchase a new residence within the period when such a purchase will result in nonrecognition of any part of such gain, or

(iii) The taxpayer's failure to make such a purchase within such period.

Any gain from the sale of the old residence which is required to be recognized shall be included in gross income for the taxable year or years in which such gain was realized. Any deficiency attributable to any portion of such gain may be assessed before the expiration of the 3-year period described in this paragraph, notwithstanding the provisions of any law or rule of law which might otherwise bar such assessment.

(2) The notification required by the preceding subparagraph shall contain all pertinent details in connection with the sale of the old residence and, where applicable, the purchase price of the new residence. The notification shall be in the form of a written statement and shall be accompanied, where appropriate, by an amended return for the year in which the gain from the sale of the old residence was realized, in order to reflect the inclusion in gross income for that year of gain required to be recognized in connection with such sale.

(j) *Effective date.* Pursuant to section 7851 (a) (1) (C), paragraphs (a), (b), (c), (d), (f), (g), and (i) of this section apply in the case of any "sale" (as defined in paragraph (b) (8) of this section) made after December 31, 1953, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939. Similarly, the rule in paragraph (h) of this section that involuntary conversions of personal residences are not to be treated as sales for purposes of section 1034 but are governed by section 1033 applies to any such involuntary conversion made after December 31, 1953, although such involuntary conversion may occur in a taxable year subject to the Internal Revenue Code of 1939. The rule in paragraph (e) of this section requiring an adjustment to the basis of a new residence, the purchase of which results (under section 1034, or section 112 (n) of the Internal Revenue Code of 1939) in the nonrecognition of gain on the sale of an old residence, applies in determining the adjusted basis of the new residence at any time following such sale, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939.

§ 1.1035 Statutory provisions; certain exchanges of insurance policies.

SEC. 1035. *Certain exchanges of insurance policies*—(a) *General rules.* No gain or loss shall be recognized on the exchange of—

(1) A contract of life insurance for another contract of life insurance or for an endowment or annuity contract; or

(2) A contract of endowment insurance—

(A) For another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or

(B) For an annuity contract; or

(3) An annuity contract for an annuity contract.

(b) *Definitions.* For the purpose of this section—

(1) *Endowment contract.* A contract of endowment insurance is a contract with a life insurance company as defined in section 801 which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

(2) *Annuity contract.* An annuity contract is a contract to which paragraph (1) applies but which may be payable during the life of the annuitant only in installments.

(3) *Life insurance contract.* A contract of life insurance is a contract to which paragraph (1) applies but which is not ordinarily payable in full during the life of the insured.

(c) *Cross references.* (1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

§ 1.1035–1 Certain exchanges of insurance policies.

Under the provisions of section 1035 no gain or loss is recognized on the exchange of:

(a) A contract of life insurance for another contract of life insurance or for an endowment or annuity contract (section 1035 (a) (1));

(b) A contract of endowment insurance for another contract of endowment insurance providing for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or an annuity contract (section 1035 (a) (2)); or

(c) An annuity contract for another annuity contract (section 1035 (a) (3)), but section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured. The exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under section 1035 (a) (3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in exchange as under the original contract. This section and section 1035 do not apply to transactions involving the exchange of an endowment contract or annuity contract for a life insurance contract, nor an annuity contract for an endowment contract. In the case of such exchanges, any gain or loss shall be recognized. In the case of exchanges which would be governed by section 1035 except for the fact that the property received in exchange consists not only of property which could otherwise be received without the recognition of gain or loss, but also of other property or money, see section 1031 (b) and (c) and the regulations thereunder. Such an exchange does not come within the provisions of section 1035. Determination of the basis of property acquired in an exchange under section 1035 (a) shall be governed by section 1031 (d) and the regulations thereunder.

§ 1.1036 Statutory provisions; stock for stock of same corporation.

SEC. 1036. *Stock for stock of same corporation*—(a) *General rule.* No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporaton is exchanged solely for preferred stock in the same corporation.

(b) *Cross references.* (1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

§ 1.1036–1 Stock for stock of the same corporation.

(a) Section 1036 permits the exchange, without the recognition of gain or loss, of common stock for common stock, or of preferred stock for preferred stock, in the same corporation. Section 1036 applies even though voting stock is exchanged for nonvoting stock or nonvoting stock is exchanged for voting stock. It is not limited to an exchange between two individual stockholders; it includes a transaction between a stockholder and the corporation. However, a transaction between a stockholder and the corporation may qualify not only under section 1036 (a), but also under section 368 (a) (1) (E) (recapitalization) or section 305 (a) (distribution of stock and stock rights). The provisions of section 1036 (a) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation. See paragraph (l) of § 1.301–1 for certain transactions treated as distributions under section 301. See paragraph (e) of § 1.368–2 for certain transactions treated as distributions under section 305 (b) (1).

(b) For rules relating to recognition of gain or loss where an exchange is not wholly in kind, see subsections (b) and (c) of section 1031. For rules relating to the basis of property acquired in an exchange described in paragraph (a) of this section, see subsection (d) of section 1031.

(c) A transfer is not within the provisions of section 1036 (a) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer (or if the property transferred is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031 (b).

Special Rules

§ 1.1051 Statutory provisions; property acquired during affiliation.

Sec. 1051. *Property acquired during affiliation.* In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined in accordance with regulations prescribed by the Secretary or his delegate, without regard to inter-company transactions in respect of which gain or loss was not recognized. For purposes of this section, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made by such corporation under chapter 6 of this subtitle (sec. 1501 and following) or under section 141 of the Internal Revenue Code of 1939 or of the Revenue Act of 1938, 1936, 1934, 1932, or 1928 shall be determined in accordance with regulations prescribed under section 1502 or in accordance with regulations prescribed under the appropriate section 141, as the case may be. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made by such corporation under chapter 6 of this subtitle or such section 141 shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 1502 or in accordance with regulations prescribed under the appropriate section 141, as the case may be.

§ 1.1051–1 Basis of property acquired during affiliation.

(a) (1) The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose of this section, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto), but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for $120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for $130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of $100,000. The basis of the assets in the hands of the Z Corporation is $100,000.

(b) The basis of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under the regulations governing the making of consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under the regulations governing the making of consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

(c) Except as otherwise provided in the regulations promulgated under section 1502 of the Internal Revenue Code of 1954 or the regulations under section 141 of the Internal Revenue Code of 1939 or the Revenue Act of 1938 (52 Stat. 447), 1936 (49 Stat. 1652), 1934 (48 Stat. 683), 1932 (47 Stat. 169), or 1928 (45 Stat. 791), the basis of property after a consolidated return period shall be the same as the basis immediately prior to the close of such period.

§ 1.1052 Statutory provisions; basis established by the Revenue Act of 1932 or 1934 or by the Internal Code of 1939.

Sec. 1052. *Basis established by the Revenue Act of 1932 or 1934 or by the Internal Revenue Code of 1939*—(a) *Revenue Act of 1932.* If the property was acquired, after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis thereof, for purposes of the Revenue Act of 1932 was prescribed by section 113 (a) (6), (7), or (9) of such Act (47 Stat. 199), then for purposes of this subtitle the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

(b) *Revenue Act of 1934.* If the property was acquired, after February 28, 1913, in any taxable year beginning before January 1, 1936, and the basis thereof, for purposes of the Revenue Act of 1934, was prescribed by section 113 (a) (6), (7), or (8) of such Act (48 Stat. 706), then for purposes of this subtitle the basis shall be the same as the basis therein prescribed in the Revenue Act of 1934.

(c) *Internal Revenue Code of 1939.* If the property was acquired, after February 28, 1913, in a transaction to which the Internal Revenue Code of 1939 applied, and the basis thereof, for purposes of the Internal Revenue Code of 1939, was prescribed by section 113 (a) (6), (7), (8), (13), (15), (18), (19), or (23) of such code, then for purposes of this subtitle the basis shall be the same as the basis therein prescribed in the Internal Revenue Code of 1939.

§ 1.1052–1 Basis of property established by Revenue Act of 1932.

Section 1052(a) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932 (47 Stat. 169), was prescribed by section 113(a) (6), (7), or (9) of that act, then for purposes of subtitle A of the Code, the basis shall be the same as the basis prescribed in the Revenue Act of 1932. For the rules applicable in determining the basis of stocks or securities under section 113 (a) (9) of the Revenue Act of 1932 in case of certain distributions after December 31, 1923, and in any taxable year beginning before January 1, 1934, see 26 CFR (1939) 39.113 (a) (12)–1 (Regulations 118).

§ 1.1052–2 Basis of property established by Revenue Act of 1934.

Section 1052(b) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 (48 Stat. 683) was prescribed by section 113(a) (6), (7), or (8) of that act, then for purposes of subtitle A of the Code, the basis shall be the same as the basis prescribed in the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning before January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112(b) (5) of the Internal Revenue Code of 1939 but which is described in section 112(b) (5) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.

§ 1.1052–3 Basis of property established by the Internal Revenue Code of 1939.

Section 1052(c) provides that if property was acquired after February 28, 1913, in a transaction to which the Internal Revenue Code of 1939 applied and the basis thereof was prescribed by section 113 (a) (6), (7), (8), (13), (15), (18), (19) or (23) of such Code, then for purposes of subtitle A of the Internal Revenue Code of 1954, the basis shall be the same as the basis prescribed in the Internal Revenue Code of 1939. In such cases, see section 113 (a) of the Internal Revenue Code of 1939 and the regulations thereunder.

§ 1.1053 Statutory provisions; basis of property acquired before March 1, 1913.

SEC. 1053. *Property acquired before March 1, 1913.* In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subtitle, adjusted (for the period before March 1, 1913) as provided in section 1016, is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

[Sec. 1053 as amended by sec. 47, Technical Amendments Act 1958 (72 Stat. 1642)]

§ 1.1053–1 Property acquired before March 1, 1913.

(a) *Basis for determining gain.* In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining gain is the cost or other basis, adjusted as provided in section 1016 and other applicable provisions of chapter 1 of the Code, or its fair market value as of March 1, 1913, whichever is greater.

(b) *Basis for determining loss.* In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining loss is the basis determined in accordance with part II (section 1011 and following), subchapter O, chapter 1 of the Code, or other applicable provisions of chapter 1 of the Code, without reference to the fair market value as of March 1, 1913.

(c) *Example.* The application of paragraphs (a) and (b) of this section may be illustrated by the following example:

Example. (i) On March 1, 1908, a taxpayer purchased for $100,000, property having a useful life of 50 years. Assuming that there were no capital improvements to the property, the depreciation sustained on the property before March 1, 1913, was $10,000 (5 years @ $2,000), so that the original cost adjusted, as of March 1, 1913, for depreciation sustained prior to that date is $90,000. On that date the property had a fair market value of $94,500 with a remaining life of 45 years.

(ii) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1954, the basis of the property is the fair market value of $94,500 as of March 1, 1913, adjusted for depreciation allowed or allowable after February 28, 1913, computed on $94,500. Thus, the substituted basis, $94,500, is reduced by the depreciation adjustment from March 1, 1913, to February 28, 1954, in the aggregate of $86,100 (41 years @ $2,100), leaving an adjusted basis for determining gain of $8,400 ($94,500 less $86,100).

(iii) For the purpose of determining loss from the sale or other disposition of such property on March 1, 1954, the basis of the property is its cost, adjusted for depreciation sustained before March 1, 1913, computed on cost, and the amount of depreciation allowed or allowable after February 28, 1913, computed on the fair market value of $94,500 as of March 1, 1913. In this example, the amount of depreciation sustained before March 1, 1913, is $10,000 and the amount of depreciation determined for the period after February 28, 1913, is $86,100. Therefore, the aggregate amount of depreciation for which the cost ($100,000) should be adjusted is $96,100 ($10,000 plus $86,100), and the adjusted basis for determining loss on March 1, 1954, is $3,900 ($100,000 less $96,100).

(d) *Fair market value.* The determination of the fair market value of property on March 1, 1913, is generally a question of fact and shall be established by competent evidence. In determining the fair market value of stock or other securities, due regard shall be given to the fair market value of the corporate assets as of such date, and other pertinent factors. In the case of property traded in on public exchanges, actual sales on or near the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced-sale price, or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time. In such a case the value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in each case.

§ 1.1054 Statutory provisions; cross references.

SEC. 1054. *Cross references.* (1) For nonrecognition of gain in connection with the transfer of obsolete vessels to the Maritime Administration under section 510 of the Merchant Marine Act, 1936, see subsection (e) of that section, as amended August 4, 1939 (46 U. S. C. 1160).

(2) For recognition of gain or loss in connection with the construction of new vessels, see section 511 of such Act, as amended (46 U. S. C. 1161).

(3) For nonrecognition of gain in connection with vessels exchanged with the Maritime Administration under section 8 of the Merchant Ship Sales Act of 1946, see subsection (a) of that section (50 U. S. C. App. 1741).

CHANGES TO EFFECTUATE F. C. C. POLICY

§ 1.1071 Statutory provisions; gain from sale or exchange to effectuate policies of Federal Communications Commission.

SEC. 1071. *Gain from sale or exchange to effectuate policies of F. C. C.*—(a) *Nonrecognition of gain or loss.* If the sale or exchange of property (including stock in a corporation) is certified by the Federal Communications Commission to be necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission with respect to the ownership and control of radio broadcasting stations, such sale or exchange shall, if the taxpayer so elects, be treated as an involuntary conversion of such property within the meaning of section 1033. For purposes of such section as made applicable by the provisions of this section, stock of a corporation operating a radio broadcasting station, whether or not representing control of such corporation, shall be treated as property similar or related in service or use to the property so converted. The part of the gain, if any, on such sale or exchange to which section 1033 is not applied shall nevertheless not be recognized, if the taxpayer so elects, to the extent that it is applied to reduce the basis for determining gain or loss on sale or exchange of property, of a character subject to the allowance for depreciation under section 167, remaining in the hands of the taxpayer immediately after the sale or exchange, or acquired in the same taxable year. The manner and amount of such reduction shall be determined under regulations prescribed by the Secretary or his delegate. Any election made by the taxpayer under this section shall be made by a statement to that effect in his return for the taxable year in which the sale or exchange takes place, and such election shall be binding for the taxable year and all subsequent taxable years.

(b) *Basis.* For basis of property acquired on a sale or exchange treated as an involuntary conversion under subsection (a), see section 1033 (c).

[Sec. 1071 as amended by sec. 48, Technical Amendments Act 1958 (72 Stat. 1642)]

§ 1.1071–1 Gain from sale or exchange to effectuate policies of Federal Communications Commission.

(a) (1) At the election of the taxpayer, section 1071 postpones the recognition of the gain upon the sale or exchange of property if the Federal Communications Commission grants the taxpayer a certificate with respect to the ownership and control of radio broadcasting stations which is in accordance with subparagraph (2) of this paragraph. Any taxpayer desiring to obtain the benefits of section 1071 shall file such certificate with the Commissioner of Internal Revenue, or the district director for the internal revenue district in which the income tax return of the taxpayer is required to be filed.

(2) (i) In the case of a sale or exchange before January 1, 1958, the certificate from the Federal Communications Commission must clearly identify the property and show that the sale or exchange is necessary or appropriate to effectuate the policies of such Commission with respect to the ownership and control of radio broadcasting stations.

(ii) In the case of a sale or exchange after December 31, 1957, the certificate from the Federal Communications Commission must clearly identify the property and show that the sale or exchange is necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, such Commission with respect to the ownership and control of radio broadcasting stations.

(3) The certificate shall be accompanied by a detailed statement showing the kind of property, the date of acquisition, the cost or other basis of the property, the date of sale or exchange, the name and address of the transferee, and the amount of money and the fair market value of the property other than money received upon such sale or exchange.

(b) Section 1071 applies only in the case of a sale or exchange made neces-

sary by reason of the Federal Communications Commission's policies as to ownership or control of radio facilities. Section 1071 does not apply in the case of a sale or exchange made necessary as a result of other matters, such as the operation of a broadcasting station in a manner determined by the Commission to be not in the public interest or in violation of Federal or State law.

(c) An election to have the benefits of section 1071 shall be made in the manner prescribed in § 1.1071–4.

(d) For purposes of section 1071, the term "radio broadcasting" includes telecasting.

§ 1.1071–2 Nature and effect of election.

(a) *Alternative elections.* (1) A taxpayer entitled to the benefits of section 1071 in respect of a sale or exchange of property may elect—

(i) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033; or

(ii) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033, and in addition elect to reduce the basis of property, in accordance with the regulations prescribed in § 1.1071–3, by all or part of the gain that would otherwise be recognized under section 1033; or

(iii) To reduce the basis of property, in accordance with the regulations prescribed in § 1.1071–3, by all or part of the gain realized upon the sale or exchange.

(2) The effect of the provisions of subparagraph (1) of this paragraph is, in general, to grant the taxpayer an election to treat the proceeds of the sale or exchange as the proceeds of an involuntary conversion subject to the provisions of section 1033, and a further election to reduce the basis of certain property owned by the taxpayer by the amount of the gain realized upon the sale or exchange to the extent of that portion of the proceeds which is not treated as the proceeds of an involuntary conversion.

(3) An election in respect to a sale or exchange under section 1071 shall be irrevocable and binding for the taxable year in which the sale or exchange takes place and for all subsequent taxable years.

(b) *Application of section 1033.* (1) If the taxpayer elects, under either paragraph (a) (1) (i) or (ii) of this section, to treat the sale or exchange as an involuntary conversion, the provisions of section 1033, as modified by section 1071, together with the regulations prescribed under such sections, shall be applicable in determining the amount of recognized gain and the basis of property acquired as a result of such sale or exchange. For the purposes of section 1071 and the regulations thereunder, stock of a corporation operating a radio broadcasting station shall be treated as property similar or related in service or use to the property sold or exchanged. Securities of such a corporation other than stock, or securities of a corporation not operating a radio broadcasting station, do not constitute property similar or related in service or use to the property sold or exchanged. If the taxpayer exercises the election referred to in paragraph (a) (1) (i) of this section, the gain realized upon such sale or exchange shall be recognized to the extent of that part of the money received upon the sale or exchange which is not expended in the manner prescribed in section 1033 and the regulations thereunder. If, however, the taxpayer exercises the elections referred to in paragraph (a) (1) (ii) of this section, the amount of the gain which would be recognized, determined in the same manner as in the case of an election under paragraph (a) (1) (i) of this section, shall not be recognized but shall be applied to reduce the basis of property, remaining in the hands of the taxpayer after such sale or exchange or acquired by him during the same taxable year, which is of a character subject to the allowance for depreciation under section 167. Such reduction of basis shall be made in accordance with and under the conditions prescribed by § 1.1071–3.

(2) In the application of section 1033 to determine the recognized gain and the basis of property acquired as a result of a sale or exchange pursuant to an election under paragraph (a) (1) (i) or (ii) of this section, the entire amount of the proceeds of such sale or exchange shall be taken into account.

(c) *Example.* The application of the provisions of section 1071 may be illustrated by the following example:

Example. A, who makes his return on a calendar year basis, sold in 1954, for $100,000 cash, stock of X Corporation, which operates a radio broadcasting station. A's basis of this stock was $75,000. The sale was certified by the Federal Communications Commission as provided in section 1071. Soon after, in the same taxable year, A used $50,000 of the proceeds of the sale to purchase stock in Y Corporation, which operates a radio broadcasting station. A elected in his 1954 return to treat such sale and purchase as an involuntary conversion subject to the provisions of section 1033. He also elected at the same time to reduce the basis of depreciable property by the amount of the gain that otherwise would be recognized under the provisions of section 1033, as made applicable by section 1071. The sale results in a recognized gain of $25,000 under section 1033. However, this gain is not recognized in this case because the taxpayer elected to reduce the basis of other property by the amount of the gain. This may be shown as follows:

(1) Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Gain realized	25,000
Proceeds of sale	$100,000
Amount expended to replace property sold	50,000
Amount not expended in manner prescribed in section 1033	50,000
Realized gain, recognized under section 1033 (not to exceed the unexpended portion of proceeds of sale)	$25,000
Less: Amount applied as a reduction of basis of depreciable property	25,000
Recognized gain for tax purposes	None

(2) The basis of Y Corporation stock in the hands of A is $50,000, computed in accordance with section 1033 and the regulations prescribed under that section. The $50,000 basis is computed as follows:

Basis of property sold (converted)	$75,000
Less: Amount of proceeds not expended	50,000
Balance	25,000
Plus amount of gain recognized under section 1033	25,000
Basis of Y Corporation stock in A's hands	50,000

§ 1.1071–3 Reduction of basis of property pursuant to election under section 1071.

(a) *General rule.* (1) In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1 of the Code which adjustments are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in the amount of the unrecognized gain under section 1071, if the taxpayer so elects. Such further adjustment shall be made only with respect to the cost or other basis of property which is of a character subject to the allowance for depreciation under section 167 (whether or not used in connection with a broadcasting business), and which remains in the hands of the taxpayer immediately after the sale or exchange in respect of which the election is made, or which is acquired by the taxpayer in the same taxable year in which such sale or exchange occurs. If the property is in the hands of the taxpayer immediately after the sale or exchange, the time of reduction of the basis is the date of the sale or exchange; in all other cases the time of reduction of the basis is the date of acquisition.

(2) The reduction of basis under section 1071 in the amount of the unrecognized gain shall be made in respect of the cost or other basis, as of the time prescribed, of all units of property of the specified character. The cost or other basis of each unit shall be decreased in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) of such unit bears to the aggregate of such adjusted bases of all units of such property, but the amount of the decrease shall not be more than the amount of such adjusted basis. If in the application of such rule the adjusted basis of any unit is reduced to zero, the process shall be repeated to reduce the adjusted basis of the remaining units of property by the portion of the unrecognized gain which is not absorbed in the first application of the rule. For such purpose the "adjusted basis" of the remaining units shall be the adjusted basis for determining gain reduced by the amount of the adjustment previously made under this section. The process shall be repeated until the entire amount of the unrecognized gain has been absorbed.

(3) The application of the provisions of this section may be illustrated by the following example:

Example. Using the facts given in the example set forth in § 1.1071–2 (c), except that the taxpayer elects to reduce the basis of depreciable property in accordance with paragraph (a) (1) (iii) of § 1.1071–2, the computation may be illustrated as follows:

Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Realized gain (recognized except for the election under § 1.1071–1)	25,000
Adjusted basis of other depreciable property in hands of A immediately after sale:	
Building	$80,000
Transmitter	16,000
Fixtures	4,000
Total	100,000
Computation of reduction:	
Building $\frac{80,000}{100,000} \times \$25,000$ (gain)	$20,000
Transmitter $\frac{16,000}{100,000} \times \$25,000$	4,000
Fixtures $\frac{4,000}{100,000} \times \$25,000$	1,000
Total reduction	25,000
New basis of assets:	
Building ($80,000 minus $20,000)	$60,000
Transmitter ($16,000 minus $4,000)	12,000
Fixtures ($4,000 minus $1,000)	3,000
Total adjusted basis after reduction under section 1071	75,000
Realized gain upon sale of X Corporation stock	$25,000
Less: Amount applied as a reduction to basis of depreciable property	25,000
Recognized gain for tax purposes	None

(b) *Special cases.* With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property of the class specified in section 1071 and this section adjusted in a manner different from the general rule set forth in paragraph (a) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of such property. The request for variations from such general rule should be filed by the taxpayer with his return for the taxable year in which he elects to have the basis of property reduced under section 1071. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121.

§ 1.1071–4 Manner of election.

(a) An election under the provisions of section 1071 shall be in the form of a written statement and shall be executed and filed in duplicate. Such statement shall be signed by the taxpayer or his authorized representative. In the case of a corporation, the statement shall be signed with the corporate name, followed by the signature and title of an officer of the corporation empowered to sign for the corporation, and the corporate seal must be affixed. An election under section 1071 to reduce the basis of property and an election under such section to treat the sale or exchange as an involuntary conversion under section 1033 may be exercised independently of each other. An election under section 1071 must be filed with the return for the taxable year in which the sale or exchange occurs. Where practicable, the certificate of the Federal Communications Commission required by § 1.1071–1 should be filed with the election.

(b) If, in pursuance of an election to have the basis of its property adjusted under section 1071, the taxpayer desires to have such basis adjusted in any manner different from the general rule set forth in paragraph (a) of § 1.1071–3, the precise method (including allocation of amounts) should be set forth in detail on separate sheets accompanying the election. Consent by the Commissioner to any departure from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121.

EXCHANGES IN OBEDIENCE TO S. E. C. ORDERS

§ 1.1081 Statutory provisions; exchanges and distributions in obedience to orders of the Securities and Exchange Commission; nonrecognition of gain or loss.

SEC. 1081. *Nonrecognition of gain or loss on exchanges or distributions in obedience to orders of S. E. C.*—(a) *Exchanges of stock or securities only.* No gain or loss shall be recognized to the transferor if stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are transferred to such corporation or to an associate company thereof which is a registered holding company or a majority-owned subsidiary company solely in exchange for stock or securities (other than stock or securities which are nonexempt property), and the exchange is made by the transferee corporation in obedience to an order of the Securities and Exchange Commission.

(b) *Exchanges and sales of property by corporations*—(1) *General rule.* No gain shall be recognized to a transferor corporation which is a registered holding company or an associate company of a registered holding company, if such corporation, in obedience to an order of the Securities and Exchange Commission, transfers property in exchange for property, and such order recites that such exchange by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member. Any gain, to the extent that it cannot be applied in reduction of basis under section 1082 (a) (2), shall be recognized.

(2) *Nonexempt property.* If any such property so received is nonexempt property, gain shall be recognized unless such nonexempt property or an amount equal to the fair market value of such property at the time of the transfer is, within 24 months of the transfer, under regulations prescribed by the Secretary or his delegate, and in accordance with an order of the Securities and Exchange Commission, expended for property other than nonexempt property or is invested as a contribution to the capital, or as paid-in surplus, of another corporation, and such order recites that such expenditure or investment by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member. If the fair market value of such nonexempt property at the time of the transfer exceeds the amount expended and the amount invested, as required in the preceding sentence, the gain, if any, to the extent of such excess, shall be recognized.

(3) *Cancellation or redemption of stock or securities.* For purposes of this subsection, a distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer) and a payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer shall be considered an expenditure for property other than nonexempt property, and if, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability shall be considered to be an expenditure by the transferor for property other than nonexempt property.

(4) *Consents.* This subsection shall not apply unless the transferor corporation consents, at such time and in such manner as the Secretary or his delegate may by regulations prescribe to the regulations prescribed under section 1082 (a) (2) in effect at the time of filing its return for the taxable year in which the transfer occurs.

(c) *Distribution of stock or securities only*—(1) *In general.* If there is distributed, in obedience to an order of the Securities and Exchange Commission, to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), without the surrender by such shareholder of stock or securities in such corporation, no gain to the distributee from the receipt of the stock or securities so distributed shall be recognized.

(2) *Special rule.* If—

(A) There is distributed to a shareholder in a corporation rights to acquire common stock in a second corporation without the surrender by such shareholder of stock in the first corporation,

(B) Such distribution is in accordance with an arrangement forming a ground for an order of the Securities and Exchange Commission issued pursuant to section 3 of the Public Utility Holding Company Act of 1935 (49 Stat. 810; 15 U. S. C. 79c) that such corporation is exempt from any provision or provisions of such Act, and

(C) Before January 1, 1958, the first corporation disposes of all of the common stock in the second corporation which it owns,

then no gain to the distributee from the receipt of the rights so distributed shall be recognized. If the first corporation does not, before January 1, 1958, dispose of all of the common stock which it owns in the second corporation, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment or the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting solely from the receipt of such rights to acquire stock, include one year immediately following the date on which the first corporation notifies the Secretary or his delegate whether or not the requirements of subparagraph (C) of the preceding sentence have been met; and such assessment and collection may be made notwithstanding any provision of law or rule of law which would otherwise prevent such assessment and collection.

(d) *Transfers within system group*—(1) *General rule.* No gain or loss shall be recognized to a corporation which is a member of a system group—

(A) If such corporation transfers property to another corporation which is a member of the same system group in exchange for other property, and the exchange by each corporation is made in obedience to an order of the Securities and Exchange Commission, or

(B) If there is distributed to such corporation as a shareholder in a corporation

which is a member of the same system group, property, without the surrender by such shareholder of stock or securities in the corporation making the distribution, and the distribution is made and received in obedience to an order of the Securities and Exchange Commission.

If an exchange by or a distribution to a corporation with respect to which no gain or loss is recognized under any of the provisions of this paragraph may also be considered to be within the provisions of subsection (a), (b), or (c), then the provisions of this paragraph only shall apply.

(2) *Sales of stock or securities.* If the property received on an exchange which is within any of the provisions of paragraph (1) consists in whole or in part of stock or securities issued by the corporation from which such property was received, and if in obedience to an order of the Securities and Exchange Commission such stock or securities (other than stock which is not preferred as to both dividends and assets) are sold and the proceeds derived therefrom are applied in whole or in part in the retirement or cancellation of stock or of securities of the recipient corporation outstanding at the time of such exchange, no gain or loss shall be recognized to the recipient corporation on the sale of the stock or securities with respect to which such order was made; except that if any part of the proceeds derived from the sale of such stock or securities is not so applied, or if the amount of such proceeds is in excess of the fair market value of such stock or securities at the time of such exchange, the gain, if any, shall be recognized, but in an amount not in excess of the proceeds which are not so applied, or in an amount not more than the amount by which the proceeds derived from such sale exceed such fair market value, whichever is the greater.

(e) *Exchanges not solely in kind*—(1) *General rule.* If an exchange (not within any of the provisions of subsection (d)) would be within the provisions of subsection (a) if it were not for the fact that property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain or loss, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property, and the loss, if any, to the recipient shall not be recognized.

(2) *Distribution treated as dividend.* If an exchange is within the provisions of paragraph (1) and if it includes a distribution which has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under such paragraph as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(f) *Conditions for application of section.* Except in the case of a distribution described in subsection (c) (2), the provisions of this section shall not apply to an exchange, expenditure, investment, distribution, or sale unless—

(1) The order of the Securities and Exchange Commission in obedience to which such exchange, expenditure, investment, distribution, or sale was made recites that such exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (49 Stat. 820; 15 U. S. C. 79k (b)),

(2) Such order specifies and itemizes the stock and securities and other property which are ordered to be acquired, transferred, received, or sold on such exchange, acquisition, expenditure, distribution, or sale, and, in the case of an investment, the investment to be made, and

(3) Such exchange, acquisition, expenditure, investment, distribution, or sale was made in obedience to such order, and was completed within the time prescribed therefor.

(g) *Nonapplication of other provisions.* If a distribution described in subsection (c) (2), or an exchange or distribution made in obedience to an order of the Securities and Exchange Commission, is within any of the provisions of this part and may also be considered to be within any of the other provisions of this subchapter or subchapter C (sec. 301 and following, relating to corporate distributions and adjustments), then the provisions of this part only shall apply.

§ 1.1081–1 Terms used.

The following terms, when used in this section and §§ 1.1081–2 to 1.1083–1, inclusive, shall have the meanings assigned to them in section 1083: "Order of the Securities and Exchange Commission"; "registered holding company"; "holding company system"; "associate company"; "majority-owned subsidiary company"; "system group"; "nonexempt property"; and "stock or securities". Any other term used in this section and §§ 1.1081–2 to 1.1083–1, inclusive, which is defined in the Internal Revenue Code of 1954, shall be given the respective definition contained in such Code.

§ 1.1081–2 Purpose and scope of exception.

(a) The general rule is that the entire amount of gain or loss from the sale or exchange of property is to be recognized (see section 1002) and that the entire amount received as a dividend is to be included in gross income. (See sections 61 and 301.) Exceptions to the general rule are provided elsewhere in subchapters C and O, chapter 1 of the Code, one of which is that made by section 1081 with respect to exchanges, sales, and distributions specifically described in section 1081. Section 1081 provides the extent to which gain or loss is not to be recognized on (1) the receipt of a distribution described in section 1081(c) (2), or (2) an exchange or sale, or the receipt of a distribution, made in obedience to an order of the Securities and Exchange Commission, which is issued to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k (b)). Section 331 provides that a distribution in liquidation of a corporation shall be treated as an exchange. Such distribution is to be treated as an exchange under the provisions of sections 1081 to 1083, inclusive. The order of the Securities and Exchange Commission must be one requiring or approving action which the Commission finds to be necessary or appropriate to effect a simplification or geographical integration of a particular public utility holding company system. For specific requirements with respect to an order of the Securities and Exchange Commission, see section 1081 (f).

(b) The requirements for nonrecognition of gain or loss as provided in section 1081 are precisely stated with respect to the following general types of transactions:

(1) The exchange that is provided for in section 1081 (a), in which stock or securities in a registered holding company or a majority-owned subsidiary company are exchanged for stock or securities.

(2) The exchange that is provided for in section 1081 (b), in which a registered holding company or an associate company of a registered holding company exchanges property for property.

(3) The distribution that is provided for in section 1081 (c) (1), in which stock or securities are distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, or the distribution that is provided for in section 1081 (c) (2), in which a corporation distributes to a shareholder, rights to acquire common stock in a second corporation.

(4) The transfer that is provided for in section 1081 (d), in which a corporation which is a member of a system group transfers property to another member of the same system group.

Certain rules with respect to the receipt of nonexempt property on an exchange described in section 1081 (a) are prescribed in section 1081 (e).

(c) These exceptions to the general rule are to be strictly construed. Unless both the purpose and the specific requirements of sections 1081 to 1083, inclusive, are clearly met, the recognition of gain or loss upon the exchange, sale, or distribution will not be postponed under those sections. Moreover, even though a taxable transaction occurs in connection or simultaneously with a realization of gain or loss to which nonrecognition is accorded, nevertheless, nonrecognition will not be accorded to such taxable transaction. In other words, the provisions of section 1081 do not extend in any case to gain or loss other than that realized from and directly attributable to a disposition of property as such, or the receipt of a corporate distribution as such, in an exchange, sale, or distribution specifically described in section 1081.

(d) The application of the provisions of part VI (section 1081 and following), subchapter O, chapter 1 of the Code, is intended to result only in postponing the recognition of gain or loss until a disposition of property is made which is not covered by such provisions, and, in the case of an exchange or sale subject to the provisions of section 1081 (b), in the reduction of basis of certain property. The provisions of section 1082 with respect to the continuation of basis and the reduction in basis are designed to effect these results. Although the time of recognition may be shifted, there must be a true reflection of income in all cases, and it is intended that the provisions of such part VI, shall not be construed or applied in such a way as to defeat this purpose.

§ 1.1081–3 Exchanges of stock or securities solely for stock or securities.

The exchange, without the recognition of gain or loss, that is provided for in section 1081 (a) must be one in which

stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are exchanged solely for stock or securities other than stock or securities which constitute nonexempt property. An exchange is not within the provisions of section 1081 (a) unless the stock or securities transferred and those received are stock or securities as defined by section 1083 (f). The stock or securities which may be received without the recognition of gain or loss are not limited to stock or securities in the corporation from which they are received. An exchange within the provisions of section 1081 (a) may be a transaction between the holder of stock or securities and the corporation which issued the stock or securities. Also the exchange may be made by a holder of stock or securities with an associate company (i. e., a corporation in the same holding company system with the issuing corporation) which is a registered holding company or a majority-owned subsidiary company. In either case, the nonrecognition provisions of section 1081 (a) apply only to the holder of the stock or securities. However, the transferee corporation must be acting in obedience to an order of the Securities and Exchange Commission directed to such corporation, if no gain or loss is to be recognized to the holder of the stock or securities who makes the exchange with such corporation. See also section 1081 (b), in case the holder of the stock or securities is a registered holding company or an associate company of a registered holding company. An exchange is not within the provisions of section 1081 (a) if it is within the provisions of section 1081 (d), relating to transfers within a system group. For treatment when nonexempt property is received, see section 1081 (e); for further limitations, see section 1081 (f).

§ 1.1081–4 Exchanges of property for property by corporations.

(a) *Application of section 1081(b).* Section 1081(b) applies only to the transfers specified therein with respect to which section 1081(d) is inapplicable, and deals only with such transfers if gain is realized upon the sale or other disposition effected by such transfers. If loss is realized section 1081(b) is inapplicable and the application of other provisions of subtitle A of the Code must be determined. See section 1081(g). If section 1081(b) is applicable, the other provisions of subchapters C and O, chapter 1 of the Code, relating to the nonrecognition of gain are inapplicable, and the conditions under which, and the extent to which, the realized gain is not recognized are set forth in paragraphs (b), (c), (d), (e), and (f) of this section.

(b) *Nonrecognition of gain; no nonexempt proceeds.* No gain is recognized to a transferor corporation upon the sale or other disposition of property transferred by such transferor corporation in exchange solely for property other than nonexempt property, as defined in section 1083 (e), but only if all of the following requirements are satisfied:

(1) The transferor corporation is, under the definition in section 1083 (b), a registered holding company or an associate company of a registered holding company;

(2) Such transfer is in obedience to an order of the Securities and Exchange Commission (as defined in section 1083 (a)) and such order satisfies the requirements of section 1081 (f);

(3) The transferor corporation has filed the required consent to the regulations under section 1082 (a) (2) (see paragraph (g) of this section); and

(4) The entire amount of the gain, as determined under section 1001, can be applied in reduction of basis under section 1082 (a) (2).

(c) *Nonrecognition of gain; nonexempt proceeds.* If the transaction would be within the provisions of paragraph (b) of this section if it were not for the fact that the property received in exchange consists in whole or in part of nonexempt property (as defined in section 1083 (e)), then no gain is recognized if such nonexempt property, or an amount equal to the fair market value of such nonexempt property at the time of the transfer,

(1) Is expended within the required 24-month period for property other than nonexempt property; or

(2) Is invested within the required 24-month period as a contribution to the capital, or as paid-in surplus, of another corporation;

but only if the expenditure or investment is made

(3) In accordance with an order of the Securities and Exchange Commission (as defined in section 1083 (a)) which satisfies the requirements of section 1081 (f) and which recites that such expenditure or investment by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member; and

(4) The required consent, waiver, and bond have been executed and filed. See paragraphs (g) and (h) of this section.

(d) *Recognition of gain in part; insufficient expenditure or investment in case of nonexempt proceeds.* If the transaction would be within the provisions of paragraph (c) of this section if it were not for the fact that the amount expended or invested is less than the fair market value of the nonexempt property received in exchange, then the gain, if any, is recognized, but in an amount not in excess of the amount by which the fair market value of such nonexempt property at the time of the transfer exceeds the amount so expended and invested.

(e) *Items treated as expenditures for the purpose of paragraphs (c) and (d) of this section.* For the purposes of paragraphs (c) and (d) of this section, the following are treated as expenditures for property other than nonexempt property:

(1) A distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer);

(2) A payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer; and

(3) If, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability.

(f) *Recognition of gain in part; inability to reduce basis.* If the transaction would be within the provisions of paragraph (b) or (c) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082 (a) (2), then the gain, if any, is recognized, but in an amount not in excess of the amount which cannot be so applied in reduction of basis. If the transaction would be within the provisions of paragraph (d) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082 (a) (2), then the gain, if any, is recognized, but in an amount not in excess of the aggregate of—

(1) The amount of gain which would be recognized under paragraph (d) of this section if there were no inability to reduce basis under section 1082 (a) (2); and

(2) The amount of gain which cannot be applied in reduction of basis under section 1082 (a) (2).

(g) *Consent to regulations under section 1082 (a) (2).* To be entitled to the benefits of the provisions of section 1081 (b), a corporation must file with its return for the taxable year in which the transfer occurs a consent to have the basis of its property adjusted under section 1082 (a) (2) (see § 1.1082–3), in accordance with the provisions of the regulations in effect at the time of filing of the return for the taxable year in which the transfer occurs. Such consent shall be made in duplicate on Form 982A in accordance with these regulations and instructions on the form or issued therewith.

(h) *Requirements with respect to expenditure or investment.* If the full amount of the expenditure or investment required for the application of paragraph (c) of this section has not been made by the close of the taxable year in which such transfer occurred, the taxpayer shall file with the return for such year an application for the benefit of the 24-month period for expenditure and investment, reciting the nature and time of the proposed expenditure or investment. When requested by the district director, the taxpayer shall execute and file (at such time and in such form) such waiver of the statute of limitations with respect to the assessment of deficiencies (for the taxable year of the transfer and for all succeeding taxable years in any of which falls any part of the period beginning with the date of the transfer and ending 24 months thereafter) as the district director may specify, and such bond with such surety as the district director may require, in an amount not in excess of double the estimated maximum income tax which would be payable if the corporation does not make the required ex-

penditure or investment within the required 24-month period.

§ 1.1081–5 Distribution solely of stock or securities.

(a) *In general.* If, without any surrender of his stock or securities as defined in section 1083(f), a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company receives stock or securities in such corporation or owned by such corporation, no gain to the shareholder will be recognized with respect to the stock or securities received by such shareholder which do not constitute nonexempt property, if the distribution to such shareholder is made by the distributing corporation in obedience to an order of the Securities and Exchange Commission directed to such corporation. A distribution is not within the provisions of section 1081 (c) (1) if it is within the provisions of section 1081 (d), relating to transfers within a system group. A distribution is also not within the provisions of section 1081 (c) (1) if it involves a surrender by the shareholder of stock or securities or a transfer by the shareholder of property in exchange for the stock or securities received by the shareholder. For further limitations, see section 1081 (f).

(b) *Special rule.* (1) If there is distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, no gain to the shareholder from the receipt of the rights shall be recognized, but only if all the following requirements are met:

(i) The rights are received by the shareholder without the surrender by the shareholder of any stock in the distributing corporation,

(ii) Such distribution is in accordance with an arrangement forming a ground for an order of the Securities and Exchange Commission issued pursuant to section 3 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79c) that the distributing corporation is exempt from any provision or provisions of such act, and

(iii) Before January 1, 1958, the distributing corporation disposes of all the common stock in the second corporation which it owns.

(2) The distributing corporation shall, as soon as practicable, notify the district director in whose district the corporation's income tax return and supporting data was filed (see paragraph (g) of § 1.1081–11), as to whether or not the requirement of subparagraph (1) (iii) of this paragraph has been met. If such requirement has not been met, the periods of limitation (sections 6501 and 6502) with respect to any deficiency, including interest and additions to the tax, resulting solely from the receipt of such rights to acquire stock, shall include one year immediately following the date of such notification; and assessment and collection shall be made notwithstanding any provisions of law or rule of law which would otherwise prevent such assessment and collection.

§ 1.1081–6 Transfers within system group.

(a) The nonrecognition of gain or loss provided for in section 1081(d)(1) is applicable to an exchange of property for other property (including money and other nonexempt property) between corporations which are all members of the same system group. The term "system group" is defined in section 1083 (d).

(b) Section 1081 (d) (1) also provides for nonrecognition of gain to a corporation which is a member of a system group if property (including money or other nonexempt property) is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, without the surrender by such shareholder of stock or securities in the distributing corporation.

(c) As stated in § 1.1081–2, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for in part VI (section 1081 and following), subchapter O, chapter 1 of the Code, even though such transaction occurs simultaneously or in connection with an exchange, sale, or distribution to which nonrecognition is specifically accorded. Therefore, nonrecognition will not be accorded to any gain or loss realized from the discharge, or the removal of the burden, of the pecuniary obligations of a member of a system group, even though such obligations are acquired upon a transfer or distribution specifically described in section 1081 (d) (1); but the fact that the acquisition of such obligations was upon a transfer or distribution specifically described in section 1081 (d) (1) will, because of the basis provisions of section 1082 (d), affect the cost to the member of such discharge or its equivalent. Thus, section 1081 (d) (1) does not provide for the nonrecognition of any gain or loss realized from the discharge of the indebtedness of a member of a system group as the result of the acquisition in exchange, sale, or distribution of its own bonds, notes, or other evidences of indebtedness which were acquired by another member of the same system group for a consideration less or more than the issuing price thereof (with proper adjustments for amortization of premiums or discounts).

(d) The provisions of paragraph (c) of this section may be illustrated by the following example:

Example. Suppose that the A Corporation and the B Corporation are both members of the same system group; that the A Corporation holds at a cost of $900 a bond issued by the B Corporation at par, $1,000; and that the A Corporation and the B Corporation enter into an exchange subject to the provisions of section 1081 (d) (1) in which the $1,000 bond of the B Corporation is transferred from the A Corporation to the B Corporation. The $900 basis reflecting the cost to the A Corporation which would have been the basis available to the B Corporation if the property transferred to it had been something other than its own securities (see § 1.1082–6) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized.

(e) No exchange or distribution may be made without the recognition of gain or loss as provided for in section 1081 (d) (1), unless all the corporations which are parties to such exchange or distribution are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 1081 (d) (1) and also may be considered to be within some other provisions of section 1081, it shall be considered that only the provisions of section 1081 (d) (1) apply and that the nonrecognition of gain or loss upon such exchange or distribution is by virtue of that section.

§ 1.1081–7 Sale of stock or securities received upon exchange by members of system group.

(a) Section 1081(d)(2) provides that to the extent that property received upon an exchange by corporations which are members of the same system group consists of stock or securities issued by the corporation from which such property was received, such stock or securities may, under certain specifically described circumstances, be sold to a party not a member of the system group, without the recognition of gain or loss to the selling corporation. The nonrecognition of gain or loss is limited, in the case of stock, to a sale of stock which is preferred as to both dividends and assets. The stock or securities must have been received upon an exchange with respect to which section 1081(d)(1) operated to prevent recognition of gain or loss to any party to the exchange. Nonrecognition of gain or loss upon the sale of such stock or securities is permitted only if the proceeds derived from the sale are applied in retirement or cancellation of stock or securities of the selling corporation which were outstanding at the time the exchange was made. It is also essential to nonrecognition of gain or loss upon the sale that both the sale of the stock or securities and the application of the proceeds derived therefrom be made in obedience to an order of the Securities and Exchange Commission. If any part of the proceeds derived from the sale is not applied in making the required retirement or cancellation of stock or securities and if the sale is otherwise within the provisions of section 1081 (d) (2), the gain resulting from the sale shall be recognized, but in an amount not in excess of the proceeds which are not so applied. In any event, if the proceeds derived from the sale of the stock or securities exceed the fair market value of such stock or securities at the time of the exchange through which they were acquired by the selling corporation, the gain resulting from the sale is to be recognized to the extent of such excess. Section 1081 (d) (2) does not provide for the nonrecognition of any gain resulting from the retirement of bonds, notes, or other evidences of indebtedness for a consideration less than the issuing price thereof. Also, that section does not provide for the nonrecognition of gain or loss upon the sale of any stock or securities received upon a distribution or otherwise than upon an exchange.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. The X Corporation and the Y Corporation, both of which make their income tax returns on a calendar year basis, are members of the same system group. As part of an exchange to which section 1081 (d) (1) is applicable the Y Corporation on June 1, 1954, issued to the X Corporation 1,000 shares of class A stock, preferred as to both dividends and assets. The fair market value of such stock at the time of issuance was $90,000 and its basis to the X Corporation was $75,000. On December 1, 1954, in obedience to an appropriate order of the Securities and Exchange Commission, the X Corporation sells all of such stock to the public for $100,000 and applies $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1954. The remaining $5,000 is not used to retire any of the X Corporation's stock or securities. Of the total gain of $25,000 realized on the disposition of the Y Corporation stock, only $10,000 is recognized (the difference between the fair market value of the stock when acquired and the amount for which it was sold), since such amount is greater than the portion ($5,000) of the proceeds not applied to the retirement of the X Corporation's stock or securities. If in this example the stock acquired by the X Corporation had not been stock of the Y Corporation issued to the X Corporation or if it had been stock not preferred as to both dividends and assets, the full amount of the gain ($25,000) realized upon its disposition would have been recognized, regardless of what was done with the proceeds.

§ 1.1081–8 Exchanges in which money or other nonexempt property is received.

(a) Under section 1081(e)(1), if in any exchange (not within any of the provisions of section 1081(d)) in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary are exchanged for stock or securities as provided for in section 1081 (a), there is received by the taxpayer money or other nonexempt property (in addition to property permitted to be received without recognition of gain), then—

(1) The gain, if any, to the taxpayer is to be recognized in an amount not in excess of the sum of the money and the fair market value of the other nonexempt property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent.

(b) If money or other nonexempt property is received from a corporation in an exchange described in paragraph (a) of this section and if the distribution of such money or other nonexempt property by or on behalf of such corporation has the effect of the distribution of a taxable dividend, then, as provided in section 1081 (e) (2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) the remainder of the gain so recognized shall be taxed as a gain from the exchange of property.

§ 1.1081–9 Requirements with respect to order of Securities and Exchange Commission.

The term "order of the Securities and Exchange Commission" is defined in section 1083(a). In addition to the requirements specified in that definition, section 1081(f) provides that, except in the case of a distribution described in section 1081 (c)(2), the provisions of section 1081 shall not apply to an exchange, expenditure, investment, distribution, or sale unless each of the following requirements is met:

(a) The order of the Securities and Exchange Commission must recite that the exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k (b)).

(b) The order shall specify and itemize the stocks and securities and other property (including money) which are ordered to be acquired, transferred, received, or sold upon such exchange, acquisition, expenditure, distribution, or sale and, in the case of an investment, the investment to be made, so as clearly to identify such property.

(c) The exchange, acquisition, expenditure, investment, distribution, or sale shall be made in obedience to such order and shall be completed within the time prescribed in such order.

These requirements were not designed merely to simplify the administration of the provisions of section 1081, and they are not to be considered as pertaining only to administrative matters. Each one of the three requirements is essential and must be met if gain or loss is not to be recognized upon the transaction.

§ 1.1081–10 Nonapplication of other provisions of the Internal Revenue Code of 1954.

The effect of section 1081(g) is that an exchange, sale, or distribution which is within section 1081 shall, with respect to the nonrecognition of gain or loss and the determination of basis, be governed only by the provisions of part VI (section 1081 and following), subchapter O, chapter 1 of the Code, the purpose being to prevent overlapping of those provisions and other provisions of subtitle A of the Code. In other words, if by virtue of section 1081 any portion of a person's gain or loss on any particular exchange, sale, or distribution is not to be recognized, then the gain or loss of such person shall be nonrecognized only to the extent provided in section 1081, regardless of what the result might have been if part VI (section 1081 and following), subchapter O, chapter 1 of the Code, had not been enacted; and similarly, the basis in the hands of such person of the property received by him in such transaction shall be the basis provided by section 1082, regardless of what the basis of such property might have been under section 1011 if such part VI had not been enacted. On the other hand, if section 1081 does not provide for the nonrecognition of any portion of a person's gain or loss (whether or not such person is another party to the same transaction referred to above), then the gain or loss of such person shall be recognized or nonrecognized to the extent provided for by other provisions of subtitle A of the Code as if such part VI had not been enacted; and similarly, the basis in his hands of the property received by him in such transaction shall be the basis provided by other provisions of subtitle A of the Code as if such part VI had not been enacted.

§ 1.1081–11 Records to be kept and information to be filed with returns.

(a) *Exchanges; holders of stock or securities.* Every holder of stock or securities who receives stock or securities and other property (including money) upon an exchange shall, if the exchange is made with a corporation acting in obedience to an order of the Securities and Exchange Commission, file as a part of his income tax return for the taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A clear description of the stock or securities transferred in the exchange, together with a statement of the cost or other basis of such stock or securities.

(2) The name and address of the corporation from which the stock or securities were received in the exchange.

(3) A statement of the amount of stock or securities and other property (including money) received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(b) *Exchanges; corporations subject to S. E. C. orders.* Each corporation which is a party to an exchange made in obedience to an order of the Securities and Exchange Commission directed to such corporation shall file as a part of its income tax return for its taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A copy of the order of the Securities and Exchange Commission directed to such corporation, in obedience to which the exchange was made.

(2) A certified copy of the corporate resolution authorizing the exchange.

(3) A clear description of all property, including all stock or securities, transferred in the exchange, together with a complete statement of the cost or other basis of each class of property.

(4) The date of acquisition of any stock or securities transferred in the exchange, and, if any of such stock or securities were acquired by the corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The name and address of all persons to whom any property was transferred in the exchange.

(6) If any property transferred in the exchange was transferred to another corporation, a copy of any order of the Securities and Exchange Commission directed to the other corporation, in obedience to which the exchange was made by such other corporation.

(7) If the corporation transfers any nonexempt property, the amount of the undistributed earnings and profits of the corporation accumulated after February

28, 1913, to the time of the exchange, computed in accordance with the last sentence in paragraph (b) of § 1.316–2.

(8) A statement of the amount of stock or securities and other property (including money) received upon the exchange, including a statement of all distributions or other dispositions made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(9) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(10) The term "exchange" shall, whenever occurring in this paragraph, be read as "exchange, expenditure, or investment".

(c) *Distributions; shareholders.* Each shareholder who receives stock or securities or other property (including money) upon a distribution made by a corporation in obedience to an order of the Securities and Exchange Commission shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of stock or securities or other property received upon the distribution, including (in case the shareholder is a corporation) a statement of all distributions or other disposition made of such stock or securities or other property by the shareholder. The amount of each class of stock or securities and each kind of property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(3) If the shareholder is a corporation, a statement showing as to each class of its stock the number of shares and percentage owned by a registered holding company or a majority-owned subsidiary company of a registered holding company, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(d) *Distributions; distributing corporations subject to S. E. C. orders.* Every corporation making a distribution in obedience to an order of the Securities and Exchange Commission shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributee upon such distribution including—

(1) A copy of the order of the Securities and Exchange Commission, in obedience to which the distribution was made.

(2) A certified copy of the corporate resolution authorizing the distribution.

(3) A statement of the amount of stock or securities or other property (including money) distributed to each shareholder. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(4) The date of acquisition of the stock or securities distributed, and, if any of such stock or securities were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the distribution, computed in accordance with the last sentence in paragraph (b) of § 1.316–2.

(6) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(e) *Sales by members of system groups.* Each corporation which is a member of a system group and which in obedience to an order of the Securities and Exchange Commission sells stock or securities received upon an exchange (made in obedience to an order of the Securities and Exchange Commission) and applies the proceeds derived therefrom in retirement or cancellation of its own stock or securities shall file as a part of its income tax return for the taxable year in which the sale is made a complete statement of all facts pertaining to the nonrecognition of gain or loss upon such sale, including—

(1) A copy of the order of the Securities and Exchange Commission in obedience to which the sale was made.

(2) A copy of the order of the Securities and Exchange Commission in obedience to which the proceeds derived from the sale were applied in whole or in part in the retirement or cancellation of its stock or securities.

(3) A certified copy of the corporate resolutions authorizing the sale of the stock or securities and the application of the proceeds derived therefrom.

(4) A clear description of the stock or securities sold, including the name and address of the corporation by which they were issued.

(5) The date of acquisition of the stock or securities sold, together with a statement of the fair market value of such stock or securities at the date of acquisition, and a copy of all orders of the Securities and Exchange Commission in obedience to which such stock or securities were acquired.

(6) The amount of the proceeds derived from such sale.

(7) The portion of the proceeds of such sale which was applied in retirement or cancellation of its stock or securities, together with a statement showing how long such stock or securities were outstanding prior to retirement or cancellation.

(8) The issuing price of its stock or securities which were retired or canceled.

(f) *Section 1081 (c) (2) distributions; shareholders.* Each shareholder who receives a distribution described in section 1081 (c) (2) (concerning rights to acquire common stock) shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all the facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of the rights received upon the distribution, stated on the basis of their fair market value at the date of the distribution.

(g) *Section 1081 (c) (2) distributions; distributing corporations.* Every corporation making a distribution described in section 1081 (c) (2) (concerning rights to acquire common stock) shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributees upon such distribution including—

(1) A copy of the arrangement forming the basis for the issuance of the order by the Securities and Exchange Commission.

(2) A copy of the order issued by the Securities and Exchange Commission pursuant to section 3 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79c).

(3) A certified copy of the corporate resolution authorizing the arrangement and the distribution.

(4) A statement of the amount of the rights distributed to each shareholder, stated on the basis of their fair market value at the date of the distribution.

(5) The date of acquisition of the stock with respect to which such rights are distributed, and, if any were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(6) The amount of the undistributed earnings and profits of the distributing corporation accumulated after February 28, 1913, to the time of the distribution, computed in accordance with the last sentence in paragraph (b) of § 1.316–2.

(h) *General requirements.* Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange or distribution to which sections 1081 to 1083, inclusive, are applicable, showing the cost or other basis of the property transferred and the amount of stock or securities and other property (including money) received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received on the exchange or distribution.

§ 1.1082 Statutory provisions; basis of property acquired in exchanges and distributions made in obedience to orders of the Securities and Exchange Commission.

SEC. 1082. *Basis for determining gain or loss*—(a) *Exchanges generally*—(1) *Exchanges subject to the provisions of section 1081 (a) or (e).* If the property was acquired on an exchange subject to the provi-

sons of section 1081 (a) or (e), or the corresponding provisions of prior internal revenue laws, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer, and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 1081 (a) to be received without the recognition of gain or loss, and in part of nonexempt property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange. This subsection shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

(2) *Exchanges subject to the provisions of section 1081 (b).* The gain not recognized on a transfer by reason of section 1081 (b) or the corresponding provisions of prior internal revenue laws shall be applied to reduce the basis for determining gain or loss on sale or exchange of the following categories of property in the hands of the transferor immediately after the transfer, and property acquired within 24 months after such transfer by an expenditure or investment to which section 1081 (b) relates on account of the acquisition of which gain is not recognized under such subsection, in the following order:

(A) Property of a character subject to the allowance for depreciation under section 167;

(B) Property (not described in subparagraph (A)) with respect to which a deduction for amortization is allowable under section 168 or 169;

(C) Property with respect to which a deduction for depletion is allowable under section 611 but not allowable under section 613;

(D) Stock and securities of corporations not members of the system group of which the transferor is a member (other than stock or securities of a corporation of which the transferor is a subsidiary);

(E) Securities (other than stock) of corporations which are members of the system group of which the transferor is a member (other than securities of the transferor or of a corporation of which the transferor is a subsidiary);

(F) Stock of corporations which are members of the system group of which the transferor is a member (other than stock of the transferor or of a corporation of which the transferor is a subsidiary);

(G) All other remaining property of the transferor (other than stock or securities of the transferor or of a corporation of which the transferor is a subsidiary).

The manner and amount of the reduction to be applied to particular property within any of the categories described in subparagraphs (A) to (G), inclusive, shall be determined under regulations prescribed by the Secretary or his delegate.

(3) *Basis in case of pre-1942 acquisition.* Notwithstanding the provisions of paragraph (1) or (2), if the property was acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 of the Internal Revenue Code of 1939 before its amendment by the Revenue Act of 1942, the basis shall be that prescribed in such section (before its amendment by such Act) with respect to such property.

(b) *Transfers to corporations.* If, in connection with a transfer subject to the provisions of section 1081 (a), (b), or (c) or the corresponding provisions of prior internal revenue laws, the property was acquired by a corporation, either as paid-in surplus or as a contribution to capital, or in consideration for stock or securities issued by the corporation receiving the property (including cases where part of the consideration for the transfer of such property to the corporation consisted of property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor on such transfer under the law applicable to the year in which the transfer was made.

(c) *Distributions of stock or securities.* If the stock or securities were received in a distribution subject to the provisions of section 1081 (c) or the corresponding provisions of prior internal revenue laws, then the basis in the case of the stock in respect of which the distribution was made shall be apportioned, under regulations prescribed by the Secretary or his delegate, between such stock and the stock or securities distributed.

(d) *Transfers within system group.* If the property was acquired by a corporation which is a member of a system group on a transfer or distribution described in section 1081 (d) (1), then the basis shall be the same as it would be in the hands of the transferor; except that if such property is stock or securities issued by the corporation from which such stock or securities were received and they were issued—

(1) As the sole consideration for the property transferred to such corporation, then the basis of such stock or securities shall be either—

(A) The same as in the case of the property transferred therefor, or

(B) The fair market value of such stock or securities at the time of their receipt, whichever is the lower; or

(2) As part consideration for the property transferred to such corporation, then the basis of such stock or securities shall be either—

(A) An amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities at the time of their receipt bears to the total fair market value of the entire consideration received, or

(B) The fair market value of such stock or securities at the time of their receipt, whichever is the lower.

§ 1.1082–1 Basis for determining gain or loss.

(a) For determining the basis of property acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942 (56 Stat. 798), see such section (before its amendment by such Act).

(b) If the property was acquired in a taxable year beginning after December 31, 1941, in any manner described in section 1082 (other than subsection (a) (2)), or section 372 (other than subsection (a) (2)) of the Internal Revenue Code of 1939 after its amendments, the basis shall be that prescribed in section 1082 with respect to such property. However, in the case of property acquired in a transaction described in section 1081 (c) (2), this paragraph is applicable only if the property was acquired in a distribution made in a taxable year subject to the Internal Revenue Code of 1954.

(c) Section 1082 makes provisions with respect to the basis of property acquired in a transfer in connection with which the recognition of gain or loss is prohibited by the provisions of section 1081 with respect to the whole or any part of the property received. In general, and except as provided in § 1.1082–3, it is intended that the basis for determining gain or loss pertaining to the property prior to its transfer, as well as the basis for determining the amount of depreciation or depletion deductible and the amount of earnings or profits available for distribution, shall continue notwithstanding the nontaxable conversion of the asset in form or its change in ownership. The continuance of the basis may be reflected in a shift thereof from one asset to another in the hands of the same owner, or in its transfer with the property from one owner into the hands of another. See also § 1.1081–2.

§ 1.1082–2 Basis of property acquired upon exchanges under section 1081 (a) or (e).

(a) In the case of an exchange of stock or securities for stock or securities as described in section 1081 (a), if no part of the gain or loss upon such exchange was recognized under section 1081, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

(b) If, in an exchange of stock or securities as described in section 1081 (a), gain to the taxpayer was recognized under section 1081 (e) on account of the receipt of money, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized upon the exchange. If, upon such exchange, there were received by the taxpayer money and other nonexempt property (not permitted to be received without the recognition of gain), and gain from the transaction was recognized under section 1081 (e), the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to the nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange.

(c) Section 1081 (e) provides that no loss may be recognized on an exchange of stock or securities for stock or securities as described in section 1081 (a), although the taxpayer receives money or other nonexempt property from the transaction. However, the basis of the property (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be apportioned to the properties received, and for this purpose there must be allocated to the nonexempt property

(other than money) an amount of such basis equivalent to the fair market value of such nonexempt property at the date of the exchange.

(d) Section 1082 (a) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. For the rule in such cases, see section 1082 (b).

(e) For purposes of this section, any reference to section 1081 shall be deemed to include a reference to corresponding provisions of prior internal revenue laws.

§ 1.1082–3 Reduction of basis of property by reason of gain not recognized under section 1081(b).

(a) *Introductory.* In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1 of the Code, and the regulations relating thereto, which are required to be made with respect to the cost or other basis of property, section 1082(a)(2) provides that a further adjustment shall be made in any case in which there shall have been a nonrecognition of gain under section 1081(b). Such further adjustment shall be made with respect to the basis of the property in the hands of the transferor immediately after the transfer and of the property acquired within 24 months after such transfer by an expenditure or investment to which section 1081(b) relates, and on account of which expenditure or investment gain is not recognized. If the property is in the hands of the transferor immediately after the transfer, the time of reduction is the day of the transfer; in all other cases the time of reduction is the date of acquisition. The effect of applying an amount in reduction of basis of property under section 1081(b) is to reduce by such amount the basis for determining gain upon sale or other disposition, the basis for determining loss upon sale or other disposition, the basis for depreciation and for depletion, and any other amount which the Code prescribes shall be the same as any of such bases. For the purposes of the application of an amount in reduction of basis under section 1081(b), property is not considered as having a basis capable of reduction if—

(1) It is money, or

(2) If its adjusted basis for determining gain at the time the reduction is to be made is zero, or becomes zero at any time in the application of section 1081 (b).

(b) *General rule.* (1) Section 1082 (a) (2) sets forth seven categories of property, the basis of which for determining gain or loss shall be reduced in the order stated.

(2) If any of the property in the first category has a basis capable of reduction, the reduction must first be made before applying an amount in reduction of the basis of any property in the second or in a succeeding category, to each of which in turn a similar rule is applied.

(3) In the application of the rule to each category, the amount of the gain not recognized shall be applied to reduce the cost or other basis of all the property in the category as follows: The cost or other basis (at the time immediately after the transfer or, if the property is not then held but is thereafter acquired, at the time of such acquisition) of each unit of property in the first category shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis at such time for determining gain, determined without regard to this section) in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) at such time of each unit of property of the taxpayer in that category bears to the aggregate of the adjusted basis (for determining gain, computed without regard to this section) at such time of all the property of the taxpayer in that category. When such adjusted basis of the property in the first category has been thus reduced to zero, a similar rule shall be applied, with respect to the portion of such gain which is unabsorbed in such reduction of the basis of the property in such category, in reducing the basis of the property in the second category. A similar rule with respect to the remaining unabsorbed gain shall be applied in reducing the basis of the property in the next succeeding category.

(c) *Special cases.* (1) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category specified in section 1082 (a) (2) adjusted in a manner different from the general rule set forth in paragraph (b) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of the taxpayer's property within a given category. A request for variations from the general rule should be filed by the taxpayer with its income tax return for the taxable year in which the transfer of property has occurred.

(2) Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121. If no such agreement is entered into by the taxpayer and the Commissioner, then the consent filed on Form 982A shall (except as otherwise provided in this subparagraph) be deemed to be a consent to the application of such general rule, and such general rule shall apply in the determination of the basis of the taxpayer's property. If, however, the taxpayer specifically states on such form that it does not consent to the application of the general rule, then, in the absence of a closing agreement, the document filed shall not be deemed a consent within the meaning of section 1081 (b) (4).

§ 1.1082–4 Basis of property acquired by corporation under section 1081 (a), 1081(b), or 1081(c) as contribution of capital or surplus, or in consideration for its own stock or securities.

If, in connection with an exchange of stock or securities for stock or securities as described in section 1081(a), or an exchange of property for property as described in section 1081(b), or an exchange as described in section 1081(c), property is acquired by a corporation by the issuance of its stock or securities, the basis of such property shall be determined under section 1082(b). If the corporation issued its stock or securities as part or sole consideration for the property acquired, the basis of the property in the hands of the acquiring corporation is the basis (adjusted to the date of the exchange) which the property would have had in the hands of the transferor if the transfer had not been made, increased in the amount of gain or decreased in the amount of loss recognized under section 1081 to the transferor upon the transfer. If any property is acquired by a corporation from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property to the corporation is the basis (adjusted to the date of acquisition) of the property in the hands of the transferor.

§ 1.1082–5 Basis of property acquired by shareholder upon tax-free distribution under section 1081(c) (1) or (2).

(a) *Stock or securities.* If there was distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), and if by virtue of section 1081 (c) (1) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the stock or securities received upon the distribution shall be determined in accordance with the following rules:

(1) If the stock or securities received upon the distribution consist solely of stock in the distributing corporation and the stock received is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

(2) If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of

this subparagraph, stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security, so that different values may properly be assigned thereto, will constitute a difference in class.

(b) *Stock rights.* If there was distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, and if by virtue of section 1081 (c) (2) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock rights so distributed to the shareholder. The basis of such stock and the stock rights received upon the distribution shall be determined in accordance with the following:

(1) The cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock rights distributed, in proportion to the respective values thereof at the time the rights are issued.

(2) The basis for determining gain or loss from the sale of a right, or from the sale of a share of stock in respect of which the distribution is made, will be the quotient of the cost or other basis, properly adjusted, assigned to the rights or the stock, divided, as the case may be, by the number of rights acquired or by the number of shares of such stock held.

(c) *Cross reference.* As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see § 1.1082–6.

§ 1.1082–6 Basis of property acquired under section 1081(d) in transactions between corporations of the same system group.

(a) If property was acquired by a corporation which is a member of a system group, from a corporation which is a member of the same system group, upon a transfer or distribution described in section 1081 (d) (1), then as a general rule the basis of such property in the hands of the acquiring corporation is the basis which such property would have had in the hands of the transferor if the transfer or distribution had not been made. Except as otherwise indicated in this section, this rule will apply equally to cases in which the consideration for the property acquired consists of stock or securities, money, and other property, or any of them, but it is contemplated that an ultimate true reflection of income will be obtained in all cases, notwithstanding any peculiarities in form which the various transactions may assume. See the example in § 1.1081–6.

(b) An exception to the general rule is provided for in case the property acquired consists of stock or securities issued by the corporation from which such stock or securities were received. If such stock or securities were the sole consideration for the property transferred to the corporation issuing such stock or securities, then the basis of the stock or securities shall be (1) the same as the basis (adjusted to the time of the transfer) of the property transferred for such stock or securities, or (2) the fair market value of such stock or securities at the time of their receipt, whichever is the lower. If such stock or securities constituted only part consideration for the property transferred to the corporation issuing such stock or securities, then the basis shall be an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities on their receipt bears to the total fair market value of the entire consideration received, except that the fair market value of such stock or securities at the time of their receipt shall be the basis therefor, if such value is lower than such amount.

(c) The application of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Suppose the A Corporation has property with an adjusted basis of $600,000 and, in an exchange in which section 1081 (d) (1) is applicable, transfers such property to the B Corporation in exchange for a total consideration of $1,000,000, consisting of (1) cash in the amount of $100,000, (2) tangible property having a fair market value of $400,000 and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with a par value and a fair market value as of the date of their receipt in the amount of $500,000. The basis to the B Corporation of the property received by it is $600,000, which is the adjusted basis of such property in the hands of the A Corporation. The basis to the A Corporation of the assets (other than cash) received by it is as follows: Tangible property, $300,000, the adjusted basis of such property to the B Corporation, the former owner; stock or securities issued by the B Corporation, $300,000, an amount equal to 500,000/1,000,000ths of $600,000.

Example (2). Suppose that in example (1) the property of the A Corporation transferred to the B Corporation had an adjusted basis of $1,100,000 instead of $600,000, and that all other factors in the example remain the same. In such case, the basis to the A Corporation of the stock or securities in the B Corporation is $500,000, which was the fair market value of such stock or securities at the time of their receipt by the A Corporation, because this amount is less than the amount established as 500,000/1,000,000ths of $1,100,000 or $550,000.

§ 1.1083 Statutory provisions; exchanges and distributions in obedience to orders of the Securities and Exchange Commission; definitions.

SEC. 1083. *Definitions*—(a) *Order of Securities and Exchange Commission.* For purposes of this part, the term "order of the Securities and Exchange Commission" means an order issued after May 28, 1938, by the Securities and Exchange Commission which requires, authorizes, permits, or approves transactions described in such order to effectuate section 11 (b) of the Public Utility Holding Company Act of 1935 (49 Stat. 820; 15 U. S. C. 79k (b)), which has become or becomes final in accordance with law.

(b) *Registered holding company; holding company system; associate company.* For purposes of this part, the terms "registered holding company", "holding company system", and "associate company" shall have the meanings assigned to them by section 2 of the Public Utility Holding Company Act of 1935 (49 Stat. 804; 15 U. S. C. 79b (a)).

(c) *Majority-owned subsidiary company.* For purposes of this part, the term "majority-owned subsidiary company" of a registered holding company means a corporation, stock of which, representing in the aggregate more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote (not including stock which is entitled to vote only on default or nonpayment of dividends or other special circumstances) is owned wholly by such registered holding company, or partly by such registered holding company and partly by one or more majority-owned subsidiary companies thereof, or by one or more majority-owned subsidiary companies of such registered holding company.

(d) *System group.* For purposes of this part, the term "system group" means one or more chains of corporations connected through stock ownership with a common parent corporation if—

(1) At least 90 percent of each class of the stock (other than (A) stock which is preferred as to both dividends and assets, and (B) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 percent of the aggregate value of all classes of stock which are not preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) The common parent corporation owns directly at least 90 percent of each class of the stock (other than stock, which is preferred as to both dividends and assets) of at least one of the other corporations; and

(3) Each of the corporations is either a registered holding company or a majority-owned subsidiary company.

(e) *Nonexempt property.* For purposes of this part, the term "nonexempt property" means—

(1) Any consideration in the form of evidences of indebtedness owed by the transferor or a cancellation or assumption of debts or other liabilities of the transferor (including a continuance of encumbrances subject to which the property was transferred);

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace;

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof);

(4) Stock or securities which were acquired from a registered holding company or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities (other than obligations described as nonexempt property in paragraph (1), (2), or (3)) were acquired in obedience to an order of the Securities and Exchange Commission or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935 (49 Stat. 820; 15 U. S. C. 79k (b));

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in paragraph (2) or (3).

(f) *Stock or securities.* For purposes of this part, the term "stock or securities" means shares of stock in any corporation, certificates of stock or interest in any corporation, notes, bonds, debentures, and evidences of indebtedness (including any evidence of an interest in or right to subscribe to or purchase any of the foregoing).

§ 1.1083–1 Definitions.

(a) *Order of the Securities and Exchange Commission.* (1) An order of the Securities and Exchange Commission as defined in section 1083(a) must be issued after May 28, 1938 (the date of the enactment of the Revenue Act of 1938 (52 Stat. 447)), and must be issued under the authority of section 11(b) or 11(e) of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79k (b), (e)), to effectuate the provisions of section 11(b) of such Act. In all cases the order must become or have become final in accordance with law; i.e., it must be valid, outstanding, and not subject to further appeal. See further sections 1083(a) and 1081(f).

(2) Section 11 (b) of the Public Utility Holding Company Act of 1935 provides:

Sec. 11. *Simplification of holding company systems.* * * *

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however,* That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

(A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

(B) All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and

(C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation.

The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company.

The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

(3) Section 11 (e) of the Public Utility Holding Company Act of 1935 provides:

Sec. 11. *Simplification of holding company systems.* * * *

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

(b) *Registered holding company, holding-company system, and associate company.* (1) Under section 5 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79e), any holding company may register by filing with the Securities and Exchange Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. A holding company shall be deemed to be registered upon receipt by the Securities and Exchange Commission of such notification of registration. As used in this part, the term "registered holding company" means a holding company whose notification of registration has been so received and whose registration is still in effect under section 5 of the Public Utility Holding Company Act of 1935. Under section 2 (a) (7) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b (a) (7)), a corporation is a holding company (unless it is declared not to be such by the Securities and Exchange Commission), if such corporation directly or indirectly owns, controls, or holds with power to vote 10 percent or more of the outstanding voting securities of a public-utility company (i. e., an electric utility company or a gas utility company as defined by such act) or of any other holding company. A corporation is also a holding company if the Securities and Exchange Commission determines, after notice and opportunity for hearing, that such corporation directly or indirectly exercises (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility company (i. e., an electric utility company or a gas utility company as defined by such act) or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such corporation be subject to the obligations, duties, and liabilities imposed upon holding companies by the Public Utility Holding Company Act of 1935 (15 U.S.C. ch. 2C). An electric utility company is defined by section 2 (a) (3) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b (a) (3)) to mean a company which owns or operates facilities used for the generation, transmission, or distribution of electrical energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company is defined by section 2 (a) (4) of such act (15 U. S. C. 79b (a) (4)), to mean a company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power. However, under certain conditions the Securities and Exchange Commission may declare a company not to be an electric utility company or a gas utility company, as the case may be, in which event the company shall not be considered an electric utility company or a gas utility company.

(2) The term "holding company system" has the meaning assigned to it by section 2 (a) (9) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b (a) (9)), and hence means any holding company, together with all its subsidiary companies (i. e., subsidiary companies within the meaning of section 2 (a) (8) of such act (15 U. S. C. 79b (a) (8)), which in general include all companies 10 percent of whose outstanding voting securities is owned directly or indirectly by such holding company) and all mutual service companies of which such holding company or any subsidiary company thereof is a member company. The term "mutual service

company" means a company approved as a mutual service company under section 13 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79m). The term "member company" is defined by section 2 (a) (14) of such act (15 U. S. C. 79b (a) (14)), to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

(3) The term "associate company" has the meaning assigned to it by section 2 (a) (10) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b (a) (10)), and hence an associate company of a company is any company in the same holding-company system with such company.

(c) *Majority-owned subsidiary company.* The term "majority-owned subsidiary company" is defined in section 1083 (c). Direct ownership by a registered holding company of more than 50 percent of the specified stock of another corporation is not necessary to constitute such corporation a majority-owned subsidiary company. To illustrate, if the H Corporation, a registered holding company, owns 51 percent of the common stock of the A Corporation and 31 percent of the common stock of the B Corporation, and the A Corporation owns 20 percent of the common stock of the B Corporation (the common stock in each case being the only stock entitled to vote), both the A Corporation and the B Corporation are majority-owned subsidiary companies.

(d) *System group.* The term "system group" is defined in section 1083 (d) to mean one or more chains of corporations connected through stock ownership with a common parent corporation, if at least 90 percent of each class of stock (other than (1) stock which is preferred as to both dividends and assets, and (2) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 percent of the aggregate value of all classes of stock which are not preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations, and if the common parent corporation owns directly at least 90 percent of each class of stock (other than stock preferred as to both dividends and assets) of at least one of the other corporations; but no corporation is a member of a system group unless it is either a registered holding company or a majority-owned subsidiary company. While the type of stock which must, for the purpose of this definition, be at least 90 percent owned may be different from the voting stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 1083 (c), as a general rule both types of ownership tests must be met under section 1083 (d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a majority-owned subsidiary company.

(e) *Nonexempt property.* The term "nonexempt property" is defined by section 1083 (e) to include—

(1) The amount of any consideration in the form of a cancellation or assumption of debts or other liabilities of the transferor (including a continuance of encumbrances subject to which the property was transferred). To illustrate, if in obedience to an order of the Securities and Exchange Commission the X Corporation, a registered holding company, transfers property to the Y Corporation in exchange for property (not nonexempt property) with a fair market value of $500,000, the X Corporation receives $100,000 of nonexempt property, if for example—

(i) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(ii) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(iii) The Y Corporation takes over the property conveyed to it by the X Corporation subject to a mortgage of $100,000.

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace.

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof).

(4) Stock or securities which were acquired from a registered holding company which acquired such stock or securities after February 28, 1938, or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities were acquired in obedience to an order of the Securities and Exchange Commission (as defined in section 1083 (a)) or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935, and are not nonexempt property within the meaning of section 1083 (e) (1), (2), or (3).

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in section 1083 (e) (2) or (3). The term "the right to receive money" includes, among other items, accounts receivable, claims for damages, and rights to refunds of taxes.

(f) *Stock or securities.* The term "stock or securities" is defined in section 1083(f) for the purposes of part VI (section 1081 and following), subchapter O, chapter 1 of the Code. As therein defined, the term includes voting trust certificates and stock rights or warrants.

WASH SALES OF STOCK OR SECURITIES

§ 1.1091 Statutory provisions; losses from wash sales of stock or securities; basis.

SEC. 1091. *Loss from wash sales of stock or securities*—(a) *Disallowance of loss deduction.* In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction for the loss shall be allowed under section 165 (c) (2); nor shall such deduction be allowed a corporation under section 165 (a) unless it is a dealer in stocks or securities, and the loss is sustained in a transaction made in the ordinary course of its business.

(b) *Stock acquired less than stock sold.* If the amount of stock or securities acquired (or covered by the contract or option to acquire) is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be determined under regulations prescribed by the Secretary or his delegate.

(c) *Stock acquired not less than stock sold.* If the amount of stock or securities acquired (or covered by the contract or option to acquire) is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility of the loss shall be determined under regulations prescribed by the Secretary or his delegate.

(d) *Unadjusted basis in case of wash sale of stock.* If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under this section or corresponding provisions of prior internal revenue laws) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.

§ 1.1091–1 Losses from wash sales of stock or securities.

(a) A taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this section as the 61-day period), he has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities. However, this prohibition does not apply (1) in the case of a taxpayer, not a corporation, if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer.

(b) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities, the provisions of this section shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were dis-

posed of (beginning with the earliest disposition). If the order of disposition of stock or securities disposed of at a loss on the same day cannot be determined, the stock or securities will be considered to have been disposed of in the order in which they were originally acquired (beginning with the earliest acquisition).

(c) Where the amount of stock or securities acquired within the 61-day period is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be those with which the stock or securities acquired are matched in accordance with the following rule: The stock or securities acquired will be matched in accordance with the order of their acquisition (beginning with the earliest acquisition) with an equal number of the shares of stock or securities sold or otherwise disposed of.

(d) Where the amount of stock or securities acquired within the 61-day period is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which resulted in the nondeductibility of the loss shall be those with which the stock or securities disposed of are matched in accordance with the following rule: The stock or securities sold or otherwise disposed of will be matched with an equal number of the shares of stock or securities acquired in accordance with the order of acquisition (beginning with the earliest acquisition) of the stock or securities acquired.

(e) The acquisition of any share of stock or any security which results in the nondeductibility of a loss under the provisions of this section shall be disregarded in determining the deductibility of any other loss.

(f) The word "acquired" as used in this section means acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law, and comprehends cases where the taxpayer has entered into a contract or option within the 61-day period to acquire by purchase or by such an exchange.

(g) The following examples illustrate the application of this section:

Example (1). A, whose taxable year is the calendar year, on December 1, 1954, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1954, purchased 100 additional shares for $9,000. On January 3, 1955, he sold the 100 shares purchased on December 1, 1954, for $9,000. Because of the provisions of section 1091, no loss from the sale is allowable as a deduction.

Example (2). A, whose taxable year is the calendar year, on September 21, 1954, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1954, he purchased 50 shares of substantially identical stock for $2,750, and on December 27, 1954, he purchased 25 additional shares of such stock for $1,125. On January 3, 1955, he sold for $4,000 the 100 shares purchased on September 21, 1954. There is an indicated loss of $1,000 on the sale of the 100 shares. Since, within the 61-day period, A purchased 75 shares of substantially identical stock, the loss on the sale of 75 of the shares ($3,750−$3,000, or $750) is not allowable as a deduction because of the provisions of section 1091. The loss on the sale of the remaining 25 shares ($1,250−$1,000, or $250) is deductible subject to the limitations provided in sections 267 and 1211. The basis of the 50 shares purchased December 21, 1954, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 3, 1955, is $2,500 (the cost of 50 of the shares sold on January 3, 1955) + $750 (the difference between the purchase price ($2,750) of the 50 shares acquired on December 21, 1954, and the selling price ($2,000) of 50 of the shares sold on January 3, 1955), or $3,250. Similarly, the basis of the 25 shares purchased on December 27, 1954, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 3, 1955, is $1,250+$125, or $1,375. See § 1.1091–2.

Example (3). A, whose taxable year is the calendar year, on September 15, 1954, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1956, for $4,000. On each of the four days from February 15, 1956, to February 18, 1956, inclusive, he purchased 50 shares of substantially identical stock for $2,000. There is an indicated loss of $1,000 from the sale of the 100 shares on February 1, 1956, but, since within the 61-day period A purchased not less than 100 shares of substantially identical stock, the loss is not deductible. The particular shares of stock the purchase of which resulted in the nondeductibility of the loss are the first 100 shares purchased within such period, that is, the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956. In determining the period for which the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956, were held, there is to be included the period for which the 100 shares purchased on September 15, 1954, and sold on February 1, 1956, were held.

§ 1.1091–2 Basis of stock or securities acquired in "wash sales".

The application of section 1091(d) may be illustrated by the following examples:

Example (1). A purchased a share of common stock of the X Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $90. No loss from the sale is recognized under section 1091. The basis of the new share is $110; that is, the basis of the old share ($100) increased by $10, the excess of the price at which the new share was acquired ($90) over the price at which the old share was sold ($80).

Example (2). A purchased a share of common stock of the Y Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $70. No loss from the sale is recognized under section 1091. The basis of the new share is $90; that is, the basis of the old share ($100) decreased by $10, the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

CAPITAL GAINS AND LOSSES

TREATMENT OF CAPITAL GAINS

§ 1.1201 Statutory provisions; alternative tax.

SEC. 1201. *Alternative tax*—(a) *Corporations.* If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 11, 511, 802 (a), 821 (a) (1) or (b), and 831 (a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) A partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and

(2) An amount equal to 25 percent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess.

In the case of a taxable year beginning before April 1, 1954, the amount under paragraph (2) shall be determined without regard to section 21 (relating to effect of change of tax rates).

(b) *Other taxpayers.* If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) A partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) An amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

[Section 1201 as amended by sec. 5 of the Life Insurance Company Tax Act 1955 (70 Stat 49)]

§ 1.1201–1 Alternative tax.

(a) *Corporations.* In case the net long-term capital gain of any corporation exceeds the net short-term capital loss, section 1201(a) imposes an alternative tax in lieu of the tax imposed by sections 11, 511, 821 (a) (1) or (b), and 831(a), if and only if such alternative tax is less than the tax imposed by such sections. For taxable years beginning after December 31, 1954, the alternative tax shall also be in lieu of the tax imposed by section 802 (a) if such alternative tax is less than the tax imposed by such section. The alternative tax is not in lieu of the personal holding company tax imposed by section 541, or of any other tax not specifically set forth in section 1201(a). The alternative tax is the sum of (1) a partial tax computed at the rates provided by sections 11, 511, 802 (a) (for taxable years beginning after December 31, 1954), 821 (a) (1) or (b), and 831 (a) on the taxable income of the taxpayer decreased by the amount of the excess of the net long-term capital gain over the net short-term capital loss, and (2) an amount equal to 25 percent of such excess or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess. In the computation of the partial tax the special deductions provided for in sections 243, 244, 245, 247, 922, and 941 shall not be recomputed as the result of the reduction of taxable income by the excess of net long-term capital gain over net short-term capital loss.

(b) *Other taxpayers.* In case the net long-term capital gain of a taxpayer (other than a corporation) exceeds the net short-term capital loss, section 1201 (b) imposes an alternative tax in lieu of the tax imposed by sections 1 and 511, if and only if such alternative tax is less than the tax imposed by sections 1 and 511. The alternative tax is not in lieu of any other tax not specifically set forth

in section 1201 (b). The alternative tax is the sum of—

(1) A partial tax, computed at the rates provided by sections 1 and 511 on the taxable income reduced by an amount equal to 50 percent of the excess of the net long-term capital gain over the net short-term capital loss, plus

(2) 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

See § 1.1–3 for rule relating to the computation of the limitation on tax under section 1 (c) in cases where the alternative tax is imposed. See § 1.34–2 (a) for rule relating to the computation of the dividend received credit under section 34 and § 1.35–1 (a) for rule relating to the computation of credit for partially tax-exempt interest under section 35 in cases where the alternative tax is imposed.

(c) *Tax-exempt trusts and organizations.* In applying section 1201 in the case of tax-exempt trusts or organizations subject to the tax imposed by section 511, the only amount which is taken into account as capital gain or loss is that which is taken into account in computing unrelated business taxable income under section 512. Under section 512, the only amount taken into account as capital gain or loss is that resulting from the application of section 631 (a), relating to the election to treat the cutting of timber as a sale or exchange.

(d) *Joint returns.* In the case of a joint return, the excess of any net long-term capital gain over any net short-term capital loss is to be determined by combining the long-term capital gains and losses and the short-term capital gains and losses of the spouses.

(e) *Application of section.* The following example illustrates the application of the provisions of section 1201 and of this section in the case of an individual taxpayer:

Example. A, a single individual, has for the calendar year 1954 taxable income (exclusive of capital gains and losses) of $99,400. He realizes in 1954 a gain of $50,000 on the sale of a capital asset held for 19 months and sustains a loss of $20,000 on the sale of a capital asset held for five months. He has no other capital gains or losses. Since the alternative tax is less than the tax otherwise computed under section 1, the tax payable is the alternative tax, that is $74,298. The tax is computed as follows:

Tax Under Section 1

Taxable income exclusive of capital gains and losses		$99,400
Net long-term capital gain (100 percent of $50,000)	$50,000	
Net short-term capital loss (100 percent of $20,000)	20,000	
Excess of net long-term capital gain over the net short-term capital loss		30,000
		129,400
Deduction of 50 percent of excess of net long-term capital gain over the net short-term capital loss (section 1202)		15,000
Taxable income		114,400
Tax under section 1		$80,136

Alternative Tax Under Section 1201 (b)

Taxable income		$114,400
Less 50 percent of excess of net long-term capital gain over net short-term capital loss (section 1201 (b) (1))		15,000
Taxable income exclusive of capital gains and losses		99,400
Partial tax (tax on $99,400)		$66,798
Plus 25 percent of $30,000		7,500
Alternative tax under section 1201 (b)		74,298

§ 1.1202 Statutory provisions; deduction for capital gains.

SEC. 1202. *Deduction for capital gains.* In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains from the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

§ 1.1202–1 Deduction for capital gains.

(a) In computing gross income, adjusted gross income, taxable income, net capital gain, and net capital loss, 100 percent of any gain or loss (computed under section 1001, recognized under section 1002, and taken into account without regard to subchapter P (section 1201 and following), chapter 1 of the Code, upon the sale or exchange of a capital asset shall be taken into account regardless of the period for which the capital asset has been held. Nevertheless, the net short-term capital gain or loss and the net long-term capital gain or loss must be separately computed. In computing the adjusted gross income or the taxable income of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of the excess is allowable as a deduction from gross income under section 1202.

(b) For the purpose of computing the deduction allowable under section 1202 in the case of an estate or trust, any long-term or short-term capital gains which, under sections 652 and 662, are includible in the gross income of its income beneficiaries as gains derived from the sale or exchange of capital assets must be excluded in determining whether, for the taxable year of the estate or trust, its net long-term capital gain exceeds its net short-term capital loss. To determine the extent to which such gains are includible in the gross income of a beneficiary, see the regulations under sections 652 and 662. For example, during 1954 a trust realized a gain of $1,000 upon the sale of stock held for 10 months. Under the terms of the trust instrument all of such gain must be distributed during the taxable year to A, the sole income beneficiary. Assuming that under section 652 or 662 A must include all of such gain in his gross income, the trust is not entitled to any deduction with respect to such gain under section 1202. Assuming A had no other capital gains or losses for 1954, he would be entitled to a deduction of $500 under section 1202. For purposes of this section, an income beneficiary shall be any beneficiary to whom an amount is required to be distributed, or is paid or credited, which is includible in his gross income.

(c) The provisions of this section may be illustrated by the following example:

Example. A, an individual, had the following transactions in 1954:

Long-term capital gain	$6,000	
Long-term capital loss	4,000	
Net long-term capital gain		$2,000
Short-term capital loss	1,800	
Short-term capital gain	300	
Net short-term capital loss		$1,500
Excess of net long-term capital gain over net short-term capital loss		500

Since the net long-term capital gain exceeds the net short-term capital loss by $500, 50 percent of the excess, or $250, is allowable as a deduction under section 1202.

TREATMENT OF CAPITAL LOSSES

§ 1.1211 Statutory provisions; limitation on capital losses.

SEC. 1211. *Limitation on capital losses—*

(a) *Corporations.* In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

(b) *Other taxpayers.* In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or $1,000, whichever is smaller. For purposes of this subsection, taxable income shall be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. If the taxpayer elects to pay the optional tax imposed by section 3, "taxable income" as used in this subsection shall be read as "adjusted gross income".

§ 1.1211–1 Limitation on capital losses.

(a) Section 1211(a) provides that, in the case of a corporation, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of the gains from such sales or exchanges, and section 1211(b) provides that, in the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed as a deduction only to the extent of the gains from such sales or exchanges, plus the taxable income of the taxpayer or $1,000, whichever is smaller. For purposes of section 1211 (b), taxable income is to be computed without regard to gains or losses from sales or exchanges of capital assets and without regard to the deductions provided in section 151 (relating to personal exemptions) or any deduction in lieu thereof. For example, the deductions available to estates and trusts under section 642 (b) are in lieu of the deductions allowed under section 151, and, in the case of estates and trusts, are to be added back to taxable income for the purposes of section 1211 (b).

(b) The provisions of section 1211 (b) may be illustrated by the following examples:

Example (1). A, an individual with one exemption allowable as a deduction under section 151, has the following transactions in 1954:

Taxable income exclusive of capital gains and losses	$4,400
Deductions provided in section 151	600
Taxable income for purposes of section 1211 (b)	5,000
Long-term capital gain	$1,000
Long-term capital loss	5,300
Net long-term capital loss	4,300
Amount deductible under section 1211 (b)	1,000

Example (2). B, an individual with one exemption allowable as a deduction under section 151, has the following transactions in 1954:

Taxable income exclusive of capital gains and losses	$90
Deductions provided in section 151	600
Taxable income for purposes of section 1211 (b)	690
Long-term capital gain	$1,000
Long-term capital loss	5,200
Net long-term capital loss	4,200
Amount deductible under section 1211 (b)	690

In example (1), the net long-term capital loss of $4,300 is allowable in 1954 only to the extent of $1,000 since the latter amount is smaller than the taxable income of $5,000. The remaining $3,300 of the net long-term capital loss becomes a net capital loss to be carried over to succeeding years. In example (2), since taxable income for purposes of section 1211 (b) is $690 and since that amount is smaller than the $4,200 net long-term capital loss and is less than $1,000, only $690 of the net long-term capital loss of $4,200 is allowable in 1954, leaving a net capital loss of $3,510 to be carried over. For carryover of a net capital loss, see § 1.1212–1.

(c) See section 582 (c) for modification of the limitation under section 1211 (a) in the case of a bank, as defined in section 581.

(d) In the case of a joint return, the limitation under section 1211 (b), relating to the allowance of losses from sales or exchanges of capital assets, is to be computed and the net capital loss determined with respect to the combined taxable income and the combined gains and losses of the spouses.

(e) In case the tax is computed under section 3 (relating to optional tax if adjusted gross income is less than $5,000) the term "taxable income" as used in section 1211 (b) shall be read as "adjusted gross income".

§ 1.1212 Statutory provisions; capital loss carryover.

SEC. 1212. *Capital loss carryover.* If for any taxable year the taxpayer has a net capital loss, the amount thereof shall be a short-term capital loss in each of the 5 succeeding taxable years to the extent that such amount exceeds the total of any net capital gains of any taxable years intervening between the taxable year in which the net capital loss arose and such succeeding taxable year. For purposes of this section, a net capital gain shall be computed without regard to such net capital loss or to any net capital losses arising in any such intervening taxable years, and a net capital loss for a taxable year beginning before October 20, 1951, shall be determined under the applicable law relating to the computation of capital gains and losses in effect before such date.

§ 1.1212–1 Net capital loss carryover.

(a) Any taxpayer sustaining a net capital loss may, under section 1212, carry over such loss to each of the five succeeding taxable years and treat it in each of such five succeeding taxable years as a short-term capital loss to the extent not allowed as a deduction against any net capital gains of any taxable years intervening between the taxable year in which the net capital loss was sustained and the taxable year to which carried. The carryover is thus applied in each succeeding taxable year to offset any net capital gain in such succeeding taxable year. The amount of the net capital loss carryover may not be included in computing a new net capital loss of a taxable year which can be carried forward to the next five succeeding taxable years. Under section 1212, a net capital loss for a taxable year beginning before October 20, 1951, is to be determined under the applicable law relating to the computation of capital gains and losses in effect before such date. Thus, where the applicable law for a taxable year beginning before October 20, 1951, provided that only certain percentages of the gain or loss recognized upon the sale or exchange of a capital asset should be taken into account in computing net capital loss, such percentages are to be taken into account in computing net capital loss for any such taxable year under section 1212. In the case of nonresident alien individuals not engaged in trade or business within the United States, see section 871 and the regulations thereunder for special rules on capital loss carryovers.

(b) The practical operation of the provisions of section 1212 may be illustrated by the following example:

Example. (1) For the taxable years 1952 to 1956, inclusive, an individual with one exemption allowable under section 151 (or corresponding provision of prior law) is assumed to have a net short-term capital loss, net short-term capital gain, net long-term capital loss, net long-term capital gain, and taxable income (net income for 1952 and 1953) as follows:

	1952	1953	1954	1955	1956
Carryover from prior years:					
From 1952		($50,000)	($29,500)	($29,500)	
From 1954				(19,500)	($13,000)
Net short-term loss (computed without regard to the carryovers)	($30,000)	(5,000)	(10,000)		
Net short-term gain (computed without regard to the carryovers)				40,000	
Net long-term loss	(20,500)		(10,000)	(5,000)	
Net long-term gain		25,000			15,000
Net income or taxable income, computed without regard to capital gains and losses, and, after 1953, without regard to the deduction provided by section 151	500	500	500	1,000	500
Net capital gain (computed without regard to the carryovers)		20,500		36,000	
Net capital loss	(50,000)		(19,500)		
Deduction allowable under section 1202			None	None	1,000
Taxable income (after deductions allowable under sections 151 and 1202)			None	None	900

(2) *Net capital loss of 1952.* The net capital loss is $50,000. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (i) gains (in this case, none) from such sales or such exchanges, and (ii) net income (computed without regard to capital gains and losses) of $500. This amount may be carried forward in full as a short-term loss to 1953. However, in 1953 there was a net capital gain of $20,500, as defined by section 117 (a) (10) (B) of the Internal Revenue Code of 1939, and limited by section 117 (c) (1) of the 1939 Code, against which this net capital loss of $50,000 is allowed in part. The remaining portion—$29,500—may be carried forward to 1954 and 1955 since there was no net capital gain in 1954. In 1955 this $29,500 is allowed in full against net capital gain of $36,000, as defined by section 1222 (9) (B) and limited by section 1212.

(3) *Net capital loss of 1954.* The net capital loss is $19,500. This figure is the excess of the losses from sales or exchanges of capital assets over the sum of (i) gains (in this case, none) from such sales or exchanges and (ii) taxable income (computed without regard to capital gains and losses and the deductions provided in section 151) of $500. This amount may be carried forward in full as a short-term loss to 1955. The net capital gain in 1955, before deduction of any carryovers, is $36,000. The $29,500 balance of the 1953 loss is first applied against the $36,000, leaving a balance of $6,500. Against this amount the $19,500 loss arising in 1954 is applied, leaving a loss of $13,000, which may be carried forward to 1956. Since this amount is treated as a short-term capital loss in 1956 under section 1212, the excess of the net long-term capital gain over the net short-term capital loss is $2,000 ($15,000 minus $13,000). Half of this excess is allowable as a deduction under section 1202. Thus, after also deducting the exemption allowed as a deduction under section 151 ($600), the taxpayer has a taxable income of $900 for 1956.

(c) (1) The following rules shall be applied in computing net capital loss carryovers by husband and wife:

(i) If a husband and wife making a joint return for any taxable year made separate returns for the preceding year, any net capital loss carryover of each spouse from such preceding taxable year may be carried forward to the taxable year as a short-term capital loss to the extent provided by section 1212.

(ii) If a joint return was made for the preceding taxable year, any net capital loss carryover from such preceding taxable year may be carried forward to the taxable year as a short-term capital loss to the extent provided by section 1212.

(iii) If a husband and wife making separate returns for any taxable year

made a joint return for the preceding taxable year, any net capital loss carryover from such preceding taxable year shall be allocated to the spouses on the basis of their individual net capital losses which gave rise to such net capital loss carryover, and the net capital loss carryover so allocated to each spouse may be carried forward by such spouse to the taxable year as a short-term capital loss to the extent provided in section 1212.

(iv) If separate returns are made both for the taxable year and the preceding taxable year, any net capital loss carryover of each spouse from such preceding taxable year may be carried forward by such spouse to the taxable year as a short-term capital loss to the extent provided in section 1212.

(2) The provisions of subparagraph (1) (i) and (iii) of this paragraph may be illustrated by the following example:

Example. If H and W, husband and wife, make a joint return for 1955, having made separate returns for 1954 in which H had a net capital loss of $3,000 and W had a net capital loss of $2,000, in their joint return for 1955 they would have a short-term capital loss of $5,000 (the sum of their separate net capital loss carryovers from 1954), allowable to the extent provided by section 1212. If, on the other hand, they make separate returns in 1955 following a joint return in 1954 in which their net capital loss was $5,000 allocable $3,000 to H and $2,000 to W, the carryover of H as a short-term capital loss for the purpose of his 1955 separate return would be $3,000 and that of W for her separate return would be $2,000, each allowable to the extent provided by section 1212.

General Rules for Determining Capital Gains and Losses

§ 1.1221 Statutory provisions; capital asset defined.

Sec. 1221. *Capital asset defined.* For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) A copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) A taxpayer whose personal efforts created such property, or

(B) A taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) An obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

§ 1.1221–1 Meaning of terms.

(a) The term "capital assets" includes all classes of property not specifically excluded by section 1221. In determining whether property is a "capital asset", the period for which held is immaterial.

(b) Property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 167 and real property used in the trade or business of a taxpayer is excluded from the term "capital assets". Gains and losses from the sale or exchange of such property are not treated as gains and losses from the sale or exchange of capital assets, except to the extent provided in section 1231. See § 1.1231–1. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term "capital assets" even though depreciation may have been allowed with respect to such property under section 23 (l) of the Internal Revenue Code of 1939 before its amendment by section 121 (c) of the Revenue Act of 1942 (56 Stat. 819). However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code.

(c) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term "capital assets" if held by a taxpayer whose personal efforts created such property, or if held by a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property. As to the application of section 1231 to the sale or exchange of such property held by such a taxpayer, see § 1.1231–1. For purposes of section 1221 (3), the phrase "similar property" includes, for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.

(d) Section 1221 (4) excludes from the definition of "capital asset" accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

(e) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term "capital assets." An obligation may be issued on a discount basis even though the price paid exceeds the face amount. Thus, although the Second Liberty Bond Act (31 U. S. C. 754) provides that United States Treasury bills shall be issued on a discount basis, the issuing price paid for a particular bill may, by reason of competitive bidding, actually exceed the face amount of the bill. Since the obligations of the type described in this paragraph are excluded from the term "capital assets", gains or losses from the sale or exchange of such obligations are not subject to the limitations provided in such subchapter P. It is, therefore, not necessary for a taxpayer (other than a life insurance company taxable under part I (section 801 and following), subchapter L, chapter 1 of the Code, as amended by the Life Insurance Company Tax Act of 1955 (70 Stat. 36), and, in the case of taxable years beginning before January 1, 1955, subject to taxation only on interest, dividends, and rents) to segregate the original discount accrued and the gain or loss realized upon the sale or other disposition of any such obligation. See section 454 (b) with respect to the original discount accrued. The provisions of this paragraph may be illustrated by the following examples:

Example (1). A (not a life insurance company) buys a $100,000, 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken into account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example (2). The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

§ 1.1222 Statutory provisions; other terms relating to capital gains and losses.

Sec. 1222. *Other terms relating to capital gains and losses.* For purposes of this subtitle—

(1) *Short-term capital gain.* The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income.

(2) *Short-term capital loss.* The term "short-term capital loss" means loss from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent that such loss is taken into account in computing taxable income.

(3) *Long-term capital gain.* The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

(4) *Long-term capital loss.* The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 6 months, if and to the extent that such loss is taken into account in computing taxable income.

(5) *Net short-term capital gain.* The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.

(6) *Net short-term capital loss.* The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

(7) *Net long-term capital gain.* The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.

(8) *Net long-term capital loss.* The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

(9) *Net capital gain*—(A) *Corporations.* In the case of a corporation, the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.

(B) *Other taxpayers.* In the case of a taxpayer other than a corporation, the term "net capital gain" means the excess of—

(i) The sum of the gains from sales or exchanges of capital assets, plus taxable income (computed without regard to the deductions provided by section 151, relating to personal exemptions or any deduction in lieu thereof) of the taxpayer or $1,000, whichever is smaller, over

(ii) The losses from such sales or exchanges.

For purposes of this subparagraph, taxable income shall be computed without regard to gains or losses from sales or exchanges of capital assets. If the taxpayer elects to pay the optional tax under section 3, the term "taxable income" as used in this subparagraph shall be read as "adjusted gross income."

(10) *Net capital loss.* The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 1211. For the purpose of determining losses under this paragraph, amounts which are short-term capital losses under section 1212 shall be excluded.

§ 1.1222–1 Other terms relating to capital gains and losses.

(a) The phrase "short-term" applies to the category of gains and losses arising from the sale or exchange of capital assets held for six months or less; the phrase "long-term" to the category of gains and losses arising from the sale or exchange of capital assets held for more than six months. The fact that some part of a loss from the sale or exchange of a capital asset may be finally disallowed because of the operation of section 1211 does not mean that such loss is not "taken into account in computing taxable income" within the meaning of that phrase as used in sections 1222(2) and 1222(4).

(b) In the definition of "net short-term capital gain", as provided in section 1222 (5), the amounts brought forward to the taxable year under section 1212 are short-term capital losses for such taxable year.

(c) Gains and losses from the sale or exchange of capital assets held for not more than six months (described as short-term capital gains and short-term capital losses) shall be segregated from gains and losses arising from the sale or exchange of such assets held for more than six months (described as long-term capital gains and long-term capital losses).

(d) In the case of a corporation, the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges, which losses include any amounts brought forward pursuant to section 1212. In the case of a taxpayer other than a corporation, the term "net capital gain" means the excess of (1) the sum of the gains from sales or exchanges of capital assets, plus taxable income (computed without regard to gains and losses from sales or exchanges of capital assets and without regard to the deductions provided by section 151, relating to personal exemptions, or any deductions in lieu thereof) of the taxpayer or $1,000, whichever is smaller, over (2) the losses from such sales or exchanges, which losses include amounts brought forward under section 1212. Thus, in the case of estates and trusts, taxable income for the purposes of section 1222 (9) (B) (i) shall be computed without regard to gains and losses from sales or exchanges of capital assets and without regard to the deductions allowed by section 642 (b) to estates and trusts in lieu of personal exemptions. In the case of a taxpayer whose tax liability is computed under section 3, the term "taxable income", for purposes of this paragraph, shall be read as "adjusted gross income." For application of the term "net capital gain," in computing the capital loss carryover under section 1212, see paragraph (b) of § 1.1212–1.

(e) The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 1211. However, amounts which are short-term capital losses under section 1212 are excluded in determining such "net capital loss".

(f) See section 165 (g) and section 166 (e), under which losses from worthless stocks, bonds, and other securities (if they constitute capital assets) are required to be treated as losses under subchapter P (section 1201 and following), Chapter 1 of the Code, from the sale or exchange of capital assets, even though such securities are not actually sold or exchanged. See also section 1231 and § 1.1231–1 for the determination of whether or not gains and losses from the involuntary conversion of capital assets and from the sale, exchange, or involuntary conversion of certain property used in the trade or business shall be treated as gains and losses from the sale or exchange of capital assets. See also section 1236 and § 1.1236–1 for the determination of whether or not gains from the sale or exchange of securities by a dealer in securities shall be treated as capital gains, or whether losses from such sales or exchanges shall be treated as ordinary losses.

(g) In the case of nonresident alien individuals not engaged in trade or business within the United States, see section 871 and the regulations thereunder for the determination of the net amount of capital gains subject to tax.

§ 1.1223 Statutory provisions; holding period of property.

SEC. 1223. *Holding period of property.* For purposes of this subtitle—

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231. For purposes of this paragraph—

(A) An involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired, and

(B) A distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under section 1081 (c) (or under section 112 (g) of the Revenue Act of 1928, 45 Stat. 818, or the Revenue Act of 1932, 48 Stat. 705), there shall be included the period for which he held the stock or securities in the distributing corporation before the receipt of the stock or securities on such distribution.

(4) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 1091 relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.

(5) In determining the period for which the taxpayer has held stock or rights to acquire stock received on a distribution, if the basis of such stock or rights is determined under section 307 (or under so much of section 1052 (c) as refers to section 113 (a) (23) of the Internal Revenue Code of 1939), there shall (under regulations prescribed by the Secretary or his delegate) be included the period for which he held the stock in the distributing corporation before the receipt of such stock or rights upon such distribution.

(6) In determining the period for which the taxpayer has held stock or securities acquired from a corporation by the exercise of rights to acquire such stock or securities, there shall be included only the period beginning with the date on which the right to acquire was exercised.

(7) In determining the period for which the taxpayer has held a residence, the acquisition of which resulted under section 1034 in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, there shall be included the period for which such other residence had been held as of the date of such sale or exchange. For purposes of this paragraph, the term "sale or exchange" includes an in-

voluntary conversion occurring after December 31, 1950, and before January 1, 1954.

(8) In determining the period for which the taxpayer has held a commodity acquired in satisfaction of a commodity futures contract there shall be included the period for which he held the commodity futures contract if such commodity futures contract was a capital asset in his hands.

(9) Any reference in this section to a provision of this title shall, where applicable, be deemed a reference to the corresponding provision of the Internal Revenue Code of 1939, or prior internal revenue laws.

(10) *Cross reference.* For special holding period provision relating to certain partnership distributions, see section 735 (b).

§ 1.1223–1 Determination of period for which capital assets are held.

(a) The holding period of property received in an exchange by a taxpayer includes the period for which the property which he exchanged was held by him, if the property received has the same basis in whole or in part for determining gain or loss in the hands of the taxpayer as the property exchanged. However, this rule shall apply, in the case of exchanges after March 1, 1954, only if the property exchanged was at the time of the exchange a capital asset in the hands of the taxpayer or property used in his trade or business as defined in section 1231(b). For the purposes of this paragraph, the term "exchange" includes the following transactions: (1) An involuntary conversion described in section 1033, and (2) a distribution to which section 355 (or so much of section 356 as relates to section 355) applies. Thus, if property acquired as the result of a compulsory or involuntary conversion of other property of the taxpayer has under section 1033 (c) the same basis in whole or in part in the hands of the taxpayer as the property so converted, its acquisition is treated as an exchange and the holding period of the newly acquired property shall include the period during which the converted property was held by the taxpayer. Thus, also, where stock of a controlled corporation is received by a taxpayer pursuant to a distribution to which section 355 (or so much of section 356 as relates to section 355) applies, the distribution is treated as an exchange and the period for which the taxpayer has held the stock of the controlled corporation shall include the period for which he held the stock of the distributing corporation with respect to which such distribution was made.

(b) The holding period of property in the hands of a taxpayer shall include the period during which the property was held by any other person, if such property has the same basis in whole or in part in the hands of the taxpayer for determining gain or loss from a sale or exchange as it would have in the hands of such other person. For example, the period for which property acquired by gift after December 31, 1920, was held by the donor must be included in determining the period for which the property was held by the taxpayer if, under the provisions of section 1015, such property has, for the purpose of determining gain or loss from the sale or exchange, the same basis in the hands of the taxpayer as it would have in the hands of the donor.

(c) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under section 1081 (c) (or under section 112 (g) of the Revenue Act of 1928 (45 Stat. 818) or the Revenue Act of 1932 (47 Stat. 197)), there shall be included the period for which he held the stock or securities in the distributing corporation before the receipt of the stock or securities on such distribution.

(d) If the acquisition of stock or securities resulted in the nondeductibility (under section 1091, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, the holding period of the newly acquired securities shall include the period for which the taxpayer held the securities with respect to which the loss was not allowable.

(e) The period for which the taxpayer has held stock, or stock subscription rights, received on a distribution shall be determined as though the stock dividend, or stock right, as the case may be, were the stock in respect of which the dividend was issued if the basis for determining gain or loss upon the sale or other disposition of such stock dividend or stock right is determined under section 307. If the basis of stock received by a taxpayer pursuant to a spin-off is determined under so much of section 1052 (c) as refers to section 113 (a) (23) of the Internal Revenue Code of 1939, and such stock is sold or otherwise disposed of in a taxable year which is subject to the Internal Revenue Code of 1954, the period for which the taxpayer has held the stock received in such spin-off shall include the period for which he held the stock of the distributing corporation with respect to which such distribution was made.

(f) The period for which the taxpayer has held stock or securities issued to him by a corporation pursuant to the exercise by him of rights to acquire such stock or securities from the corporation will, in every case and whether or not the receipt of taxable gain was recognized in connection with the distribution of the rights, begin with and include the day upon which the rights to acquire such stock or securities were exercised. A taxpayer will be deemed to have exercised rights received from a corporation to acquire stock or securities therein where there is an expression of assent to the terms of such rights made by the taxpayer in the manner requested or authorized by the corporation.

(g) The period for which the taxpayer has held a residence, the acquisition of which resulted under the provisions of section 1034 in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, shall include the period for which such other residence had been held as of the date of such sale or exchange. See § 1.1034–1. For purposes of this paragraph, the term "sale or exchange" includes an involuntary conversion occurring after December 31, 1950, and before January 1, 1954.

(h) If a taxpayer accepts delivery of a commodity in satisfaction of a commodity futures contract, the holding period of the commodity shall include the period for which the taxpayer held the commodity futures contract, if such futures contract was a capital asset in his hands.

(i) If shares of stock in a corporation are sold from lots purchased at different dates or at different prices and the identity of the lots cannot be determined, the rules prescribed by the regulations under section 1012 for determining the cost or other basis of such stocks so sold or transferred shall also apply for the purpose of determining the holding period of such stock.

(j) Any reference in section 1223 or this section to another provision of the Internal Revenue Code of 1954 is, where applicable, to be deemed a reference to the corresponding provision of the Internal Revenue Code of 1939, or prior internal revenue laws. The provisions of prior internal revenue laws here intended are the sections referred to in the sections of the Internal Revenue Code of 1939 which correspond to the sections of the Internal Revenue Code of 1954 referred to in section 1223. Thus, the sections corresponding to section 1081(c) are section 371(c) of the Revenue Act of 1938 (52 Stat. 553) and section 371(c) of the Internal Revenue Code of 1939. The sections corresponding to section 1091 are section 118 of each of the following: The Revenue Acts of 1928 (45 Stat. 826), 1932 (47 Stat. 208), 1934 (48 Stat. 715), 1936 (49 Stat. 1692), 1938 (52 Stat. 503), and the Internal Revenue Code of 1939.

Special Rules for Determining Capital Gains and Losses

§ 1.1231 Statutory provisions; property used in the trade or business and involuntary conversions.

Sec. 1231. *Property used in the trade or business and involuntary conversions*—(a) *General rule.* If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversation (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection—

(1) In determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply; and

(2) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

In the case of any property used in the trade or business and of any capital asset held for more than 6 months and held for the production of income, this subsection shall not apply to any loss, in respect of which the taxpayer is not compensated for by insurance in any amount, arising from fire, storm, shipwreck, or other casualty, or from theft.

(b) *Definition of property used in the trade or business.* For purposes of this section—

(1) *General rule.* The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) A copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(2) *Timber or coal.* Such term includes timber and coal with respect to which section 631 applies.

(3) *Livestock.* Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(4) *Unharvested crop.* In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as "property used in the trade or business."

[Sec. 1231 as amended by sec. 49, Technical Amendments Act 1958 (72 Stat. 1642)]

§ 1.1231–1 Gains and losses from the sale or exchange of certain property used in the trade or business.

(a) *In general.* Section 1231 provides that a taxpayer's gains and losses from the disposition (including involuntary conversion) of assets described in that section as "property used in the trade or business" and from the involuntary conversion of capital assets held for more than 6 months shall be treated as long-term capital gains and losses if the total gains exceed the total losses. If the total gains do not exceed the total losses, all such gains and losses are treated as ordinary gains and losses. Therefore, if the taxpayer has no gains subject to section 1231, a recognized loss from the condemnation (or from a sale or exchange under threat of condemnation) of even a capital asset held for more than 6 months is an ordinary loss. Capital assets subject to section 1231 treatment include only capital assets involuntarily converted. The noncapital assets subject to section 1231 treatment are (1) depreciable business property and business real property held for more than 6 months, other than stock in trade and certain copyrights and artistic property; (2) timber and coal, but only to the extent that section 631 applies thereto; and (3) certain livestock and unharvested crops. See paragraph (c) of this section.

(b) *Treatment of gains and losses.* For the purpose of applying section 1231, a taxpayer must aggregate his recognized gains and losses from—

(1) The sale, exchange, or involuntary conversion of property used in the trade or business (as defined in section 1231 (b)), and

(2) The involuntary conversion (but not sale or exchange) of capital assets held for more than 6 months.

If the gains to which section 1231 applies exceed the losses to which the section applies, the gains and losses are treated as long-term capital gains and losses and are subject to the provisions of parts I and II (section 1201 and following), subchapter P, chapter 1 of the Code, relating to capital gains and losses. If the gains to which section 1231 applies do not exceed the losses to which the section applies, the gains and losses are treated as ordinary gains and losses. Therefore, in the latter case, a loss from the involuntary conversion of a capital asset held for more than 6 months is treated as an ordinary loss and is not subject to the limitation on capital losses in section 1211. The phrase "involuntary conversion" is defined in paragraph (e) of this section.

(c) *Transactions to which section applies.* Section 1231 applies to recognized gains and losses from the following:

(1) The sale, exchange, or involuntary conversion of property held for more than 6 months and used in the taxpayer's trade or business, which is either real property or is of a character subject to the allowance for depreciation under section 167 (even though fully depreciated), and which is not—

(i) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of business;

(ii) A copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in section 1221 (3); or

(iii) Livestock held for draft, breeding, or dairy purposes, except to the extent included under subparagraph (4) of this paragraph, or poultry.

(2) The involuntary conversion of capital assets held for more than 6 months.

(3) The cutting or disposal of timber, or the disposal of coal, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) The sale, exchange, or involuntary conversion of livestock if the requirements of § 1.1231–2 are met.

(5) The sale, exchange, or involuntary conversion of unharvested crops on land which is (i) used in the taxpayer's trade or business and held for more than 6 months, and (ii) sold or exchanged at the same time and to the same person. See paragraph (f) of this section.

For purposes of section 1231, the phrase "property used in the trade or business" means property described in this paragraph (other than property described in subparagraph (2) of this paragraph). Notwithstanding any of the provisions of this paragraph, section 1231(a) does not apply to losses described in paragraph (e)(2) of this section.

(d) *Extent to which gains and losses are taken into account.* All gains and losses to which section 1231 applies must be taken into account in determining whether and to what extent the gains exceed the losses. For the purpose of this computation, the provisions of section 1211 limiting the deduction of capital losses do not apply, and no losses are excluded by that section. With that exception, gains are included in the computations under section 1231 only to the extent that they are taken into account in computing gross income, and losses are included only to the extent that they are taken into account in computing taxable income. The following are examples of gains and losses not included in the computations under section 1231:

(1) Losses of a personal nature which are not deductible by reason of section 165 (c) or (d), such as losses from the sale of property held for personal use;

(2) Losses which are not deductible under section 267 (relating to losses with respect to transactions between related taxpayers) or section 1091 (relating to losses from wash sales);

(3) Gain on the sale of property (to which section 1231 applies) reported for any taxable year on the installment method under section 453, except to the extent the gain is to be reported under section 453 for the taxable year; and

(4) Gains and losses which are not recognized under section 1002, such as those to which sections 1031 through 1036, relating to common nontaxable exchanges, apply.

(e) *Involuntary conversion*—(1) *General rule.* For purposes of section 1231, the terms "compulsory or involuntary conversion" and "involuntary conversion" of property mean the conversion of property into money or other property as a result of complete or partial destruction, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof. Losses upon the complete or partial destruction, theft, seizure, requisition or condemnation of property are treated as losses upon an involuntary conversion whether or not there is a conversion of the property into other property or money unless subparagraph (2) of this paragraph applies. For example, if a capital asset held for more than 6 months, with an adjusted basis of $400, but not held for the production of income, is stolen, and the loss is not compensated for by insurance or otherwise, section 1231 applies to the $400 loss.

(2) *Certain uninsured losses.* Notwithstanding the provisions of subparagraph (1) of this paragraph, losses sustained during a taxable year beginning after December 31, 1957, with respect to both property used in the trade or business and any capital asset held for more than 6 months and held for the production of income, which losses arise from fire, storm, shipwreck, or other casualty, or from theft, and which are not compensated for by insurance in any

amount, are not losses to which section 1231(a) applies. Such losses shall not be taken into account in applying the provisions of this section.

(f) *Unharvested crops.* Section 1231 does not apply to a sale, exchange, or involuntary conversion of an unharvested crop if the taxpayer retains any right or option to reacquire the land the crop is on, directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). The length of time for which the crop, as distinguished from the land, is held is immaterial. A leasehold or estate for years is not "land" for the purpose of section 1231.

(g) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). A, an individual, makes his income tax return on the calendar year basis. A's recognized gains and losses for 1957 of the kind described in section 1231 are as follows:

	Gains	Losses
1. Gain on sale of machinery, used in the business and subject to an allowance for depreciation, held for more than 6 months	$4,000	
2. Gain reported in 1957 (under sec. 453) on installment sale in 1956 of factory premises used in the business (including building and land, each held for more than 6 months)	6,000	
3. Gain reported in 1957 (under sec. 453) on installment sale in 1957 of land held for more than 6 months, used in the business as a storage lot for trucks	2,000	
4. Gain on proceeds from requisition by Government of boat, held for more than 6 months, used in the business and subject to an allowance for depreciation	500	
5. Loss upon the destruction by fire of warehouse, held for more than 6 months and used in the business (excess of adjusted basis of warehouse over compensation by insurance, etc.)		$3,000
6. Loss upon theft of unregistered bearer bonds, held for more than 6 months		5,000
7. Loss in storm of pleasure yacht, purchased in 1950 for $1,800 and having a fair market value of $1,000 at the time of the storm		1,000
8. Total gains	12,500	
9. Total losses		9,000
10. Excess of gains over losses	3,500	

Since the aggregate of the recognized gains ($12,500) exceeds the aggregate of the recognized losses ($9,000), such gains and losses are treated under section 1231 as gains and losses from the sale or exchange of capital assets held for more than six months. For any taxable year ending after December 31, 1957, the $5,000 loss upon theft of bonds (item 6) would not be taken into account under section 1231. See paragraph (e)(2) of this section.

Example (2). If in example (1), A also had a loss of $4,000 from the sale under threat of condemnation of a capital asset acquired for profit and held for more than six months, then the gains ($12,500) would not exceed the losses ($9,000 plus $4,000, or $13,000). Neither the loss on that sale nor any of the other items set forth in example (1) would then be treated as gains and losses from the sale or exchange of capital assets, but all of such items would be treated as ordinary gains and losses. Likewise, if A had no other gain or loss, the $4,000 loss would be treated as an ordinary loss.

Example (3). A's yacht, used for pleasure and acquired for that use in 1945 at a cost of $25,000, was requisitioned by the Government in 1957 for $15,000. A sustained no loss deductible under section 165 (c) and since no loss with respect to the requisition is recognizable, the loss will not be included in the computations under section 1231.

§ 1.1231–2 Livestock held for draft, breeding, or dairy purposes.

(a) Section 1231 applies to the sale, exchange, or involuntary conversion of livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. For the purposes of section 1231, the term "livestock" is given a broad, rather than a narrow, interpretation and includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. However, it does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.

(b) Whether or not livestock is held by the taxpayer for draft, breeding, or dairy purposes depends upon all of the facts and circumstances in each case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal. However, a draft, breeding, or dairy purpose may be present if an animal is disposed of within a reasonable time after its intended use for such purpose is prevented or made undesirable by reason of accident, disease, drought, unfitness of the animal for such purpose, or a similar factual circumstance. Under certain circumstances, an animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may be considered as held for draft, breeding, or dairy purposes. However, an animal is not held by the taxpayer for draft, breeding, or dairy purposes merely because it is suitable for such purposes or merely because it is held by the taxpayer for sale to other persons for use by them for such purposes. Furthermore, an animal held by the taxpayer for other purposes is not considered as held for draft, breeding, or dairy purposes merely because of a negligible use of the animal for such purposes or merely because of the use of the animal for such purposes as an ordinary or necessary incident to the other purposes for which the animal is held.

(c) These principles may be illustrated by the following examples:

Example (1). An animal intended by the taxpayer for use by him for breeding purposes is discovered to be sterile or unfit for the breeding purposes for which it was held, and is disposed of within a reasonable time thereafter. This animal is considered as held for breeding purposes.

Example (2). The taxpayer retires from the breeding or dairy business and sells his entire herd, including young animals which would have been used by him for breeding or dairy purposes if he had remained in business. These young animals are considered as held for breeding or dairy purposes. The same would be true with respect to young animals which would have been used by the taxpayer for breeding or dairy purposes but which are sold by him in reduction of his breeding or dairy herd, because of, for example, drought.

Example (3). A taxpayer in the business of raising hogs for slaughter customarily breeds sows to obtain a single litter to be raised by him for sale, and sells these brood sows after obtaining the litter. Even though these brood sows are held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business, they are considered as held for breeding purposes.

Example (4). A taxpayer in the business of raising horses for sale to others for use by them as draft horses uses them for draft purposes on his own farm in order to train them. This use is an ordinary or necessary incident to the purpose of selling the animals, and, accordingly, these horses are not considered as held for draft purposes.

Example (5). The taxpayer is in the business of raising registered cattle for sale to others for use by them as breeding cattle. It is the business practice of this particular taxpayer to breed the offspring of his herd which he is holding for sale to others prior to sale in order to establish their fitness for sale as registered breeding cattle. In such case, the taxpayer's breeding of such offspring is an ordinary and necessary incident to his holding them for the purpose of selling them as bred heifers or proven bulls and does not demonstrate that the taxpayer is holding them for breeding purposes. However, those cattle held by the taxpayer as additions or replacements to his own breeding herd to produce calves are considered to be held for breeding purposes, even though they may not actually have produced calves.

Example (6). A taxpayer, engaged in the business of buying cattle and fattening them for slaughter, purchased cows with calf. The calves were born while the cows were held by the taxpayer. These cows are not considered as held for breeding purposes.

§ 1.1232 Statutory provisions; bonds and other evidences of indebtedness.

SEC. 1232. *Bonds and other evidences of indebtedness*—(a) *General rule.* For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.* Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) *Sale or exchange*—(A) *General rule.* Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

(i) An amount equal to the original issue discount (as defined in subsection (b)), or

(ii) If at the time of original issue there was no intention to call the bond or other evidence of indebtedness before maturity, an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

(B) *Exceptions.* This paragraph shall not apply to—

(i) Obligations the interest on which is not includible in gross income under section 103 (relating to certain governmental obligations), or

(ii) Any holder who has purchased the bond or other evidence of indebtedness at a premium.

(C) *Double inclusion in income not required.* This section shall not require the inclusion of any amount previously includible in gross income.

(b) *Definitions*—(1) *Original issue discount.* For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) *Issue price.* In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond. For purposes of this paragraph, the terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof.

(3) *Issue date.* In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "date of original issue" means the date on which the issue was first sold to the public at the issue price. In the case of privately placed issues of bonds or other evidences of indebtedness, the term "date of original issue" means the date on which each such bond or other evidence of indebtedness was sold by the issuer.

(c) *Bond with unmatured coupons detached.* If a bond or other evidence of indebtedness issued at any time with interest coupons—

(1) Is purchased after August 16, 1954, and before January 1, 1958, and the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, or

(2) Is purchased after December 31, 1957, and the purchaser does not receive all the coupons which first become payable after the date of the purchase,

then the gain on the sale or other disposition of such evidence of indebtedness by such purchaser (or by a person whose basis is determined by reference to the basis in the hands of such purchaser) shall be considered as gain from the sale or exchange of property which is not a capital asset to the extent that the fair market value (determined as of the time of the purchase) of the evidence of indebtedness with coupons attached exceeds the purchase price. If this subsection and subsection (a)(2)(A) apply with respect to gain realized on the sale or exchange of any evidence of indebtedness, then subsection (a)(2)(A) shall apply with respect to that part of the gain to which this subsection does not apply.

(d) *Cross reference.* For special treatment of face-amount certificates on retirement, see section 72.

[Sec. 1232 as amended by secs. 50 and 51, Technical Amendments Act 1958 (72 Stat. 1642, 1643); sec. 3(e), Life Insurance Company Income Tax Act 1959 (73 Stat. 140)]

§ 1.1232–1 Bonds and other evidences of indebtedness; scope of section.

(a) *In general.* Section 1232 applies to any bond, debenture, note, or certificate or other evidence of indebtedness (referred to in this section and §§ 1.1232–2 through 1.1232–4 as an obligation) (1) which is a capital asset in the hands of the taxpayer, and (2) which is issued by any corporation, or by any government or political subdivision thereof. In general, section 1232(a)(1) provides that the retirement of an obligation, other than certain obligations issued before January 1, 1955, is considered to be an exchange and, therefore, is usually subject to capital gain or loss treatment; and section 1232(a)(2) provides that in the case of a gain realized on the sale or exchange of certain obligations issued at a discount after December 31, 1954, the amount of gain equal to such discount or, under certain circumstances, the amount of gain equal to a specified portion of such discount, constitutes ordinary income. Section 1232(c) treats as ordinary income a portion of any gain realized upon the disposition of (i) coupon obligations which were acquired after August 16, 1954, and before January 1, 1958, without all coupons maturing more than 12 months after purchase attached, and (ii) coupon obligations which were acquired after December 31, 1957, without all coupons maturing after the date of purchase attached.

(b) *Requirement that obligations be capital assets.* In order for section 1232 to be applicable, an obligation must be a capital asset in the hands of the taxpayer. See section 1221 and the regulations thereunder. Obligations held by a dealer in securities (except as provided in section 1236) or obligations arising from the sale of inventory or personal services by the holder are not capital assets.

(c) *Face-amount certificates.* The taxability of amounts received under "face-amount certificates", as defined in sections 2(a)(15) and 4 of the Investment Company Act of 1940 (15 U. S. C. 80a–2 and 80a–4) which are issued after December 31, 1954, is governed by section 72, rather than section 1232, and is, therefore, subject to the limit on tax provided by section 72(e)(3). See section 72(1).

§ 1.1232–2 Retirement.

Section 1232(a)(1) provides that any amount received by the holder upon the retirement of an obligation shall be considered as an amount received in exchange therefor. However, section 1232(a)(1) does not apply to obligations issued before January 1, 1955, which were not issued with interest coupons or in registered form, or which were not in registered form on March 1, 1954. With respect to certain obligations held by a bank, see section 582(c).

§ 1.1232–3 Gain upon sale or exchange of obligations issued at a discount after December 31, 1954.

(a) *General rule*—(1) *Sale or exchange before January 1, 1958.* Gain realized upon the sale or exchange before January 1, 1958, of an obligation issued at a discount after December 31, 1954, and held by the taxpayer for more than six months, shall be considered ordinary income to the extent it equals a specified portion of the "original issue discount", and the balance, if any, of the gain shall be considered as long-term capital gain. The term "original issue discount" is defined in paragraph (b) of this section. The computation of the amount of gain which constitutes ordinary income is illustrated in paragraph (c) of this section.

(2) *Sale or exchange after December 31, 1957.* In the case of gain realized upon the sale or exchange after December 31, 1957, of an obligation issued at a discount after December 31, 1954, and held by the taxpayer for more than six months, section 1232(a)(2)(A) provides that such gain shall be considered ordinary income to the extent it does not exceed—

(i) An amount equal to the entire "original issue discount", or

(ii) If at the time of original issue there was no intention to call the bond or other evidence of indebtedness before maturity, a portion of the "original issue discount" determined in accordance with paragraph (c) of this section,

and the balance, if any, of the gain shall be considered as long-term capital gain. The terms "original issue discount" and "intention to call the bond or other evidence of indebtedness before maturity" are defined in paragraph (b) of this section.

(3) *Obligations issued before January 1, 1955.* Whether gain representing original issue discount realized upon the sale or exchange of obligations issued at a discount before January 1, 1955, is capital gain or ordinary income shall be determined without reference to section 1232.

(b) *Definitions*—(1) *Original issue discount.* For purposes of section 1232, the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. The stated redemption price is determined without regard to optional call dates. If the original issue discount is less than one-fourth of one percent of the stated redemption price at maturity, multiplied by the number of full years from the date of original issue to maturity, then the discount shall be considered to be zero. For example, a 10-year bond with a stated redemption price at maturity of $100 issued at $98 would be regarded as having an original issue dis-

count of zero. Thus, any gain realized by the holder would be a long-term capital gain if the bond was a capital asset in the hands of the holder and held by him for more than six months. However, if the bond were issued at $97.50 or less, the original issue discount would not be considered zero. The term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement, including dividends payable at that time. Thus, in the case of face-amount certificates, the redemption price at maturity is the price as modified through changes such as extensions of the purchase agreement and includes any dividends which are payable at maturity.

(2) *Issue price.* The term "issue price" in the case of obligations registered with the Securities and Exchange Commission means the initial offering price to the public at which price a substantial amount of such obligations were sold. For this purpose, the term "the public" does not include bond houses and brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. Ordinarily, the issue price will be the first price at which the obligations were sold to the public, and the issue price will not change if, due to market developments, part of the issue must be sold at a different price. When obligations are privately placed, the issue price of each obligation is the price paid by the first buyer of the particular obligation, irrespective of the issue price of the remainder of the issue. The terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. Thus, all amounts paid by the purchaser under the purchase agreement or a modification of it are included in the issue price, such as amounts paid upon face-amount certificates or installment trust certificates in which the purchaser contracts to make a series of payments which will be returnable with an increment at a later date.

(3) *Date of original issue.* In the case of issues of obligations which are registered with the Securities and Exchange Commission, the term "date of original issue" means the date on which the issue was first sold to the public at the issue price. In the case of issues which are privately placed, the term "date of original issue" means the date on which each obligation was sold to the original purchaser.

(4) *Intention to call before maturity*—(i) *Meaning of term.* For purposes of section 1232, the term "intention to call the bond or other evidence of indebtedness before maturity" means an understanding between (*a*) the issuing corporation (such corporation is hereinafter referred to as the "issuer"), and (*b*) the original purchaser of such obligation (or, in the case of obligations constituting part of an issue, any of the original purchasers of such obligations) that the issuer will redeem the obligation before maturity. For purposes of this subparagraph, the term "original purchaser" does not include persons or organizations acting in the capacity of underwriters or dealers, who purchased the obligation for resale in the ordinary course of their trade or business. It is not necessary that the issuer's intention to call the obligation before maturity be communicated directly to the original purchaser by the issuer. The understanding to call before maturity need not be unconditional; it may, for example, be dependent upon the financial condition of the issuer on the proposed early call date.

(ii) *Proof of intent*—(*a*) *In general.* Ordinarily, the existence or non-existence of an understanding at the time of original issue that the obligation will be redeemed before maturity shall be determined by an examination of all of the circumstances under which the obligation was issued and held. The fact that the obligation is issued with provisions on its face giving the issuer the privilege of redeeming the obligation before maturity is not determinative of an intention to call before maturity; likewise, the absence of such provision is not determinative of the absence of an intention to call before maturity. However, such provision, or the absence of such provision, is one of the circumstances to be given consideration along with other factors in determining whether an understanding existed. If the obligation was part of an issue registered with the Securities and Exchange Commission and was sold to the public (whether or not sold directly to the public by the obligor) without representation to the public that the obligor intends to call the obligation before maturity, there shall be a presumption that no intention to call the obligation before maturity was in existence at the time of original issue. The existence of a provision on the face of an obligation giving the issuer the privilege of redeeming the obligation before maturity shall not in and of itself overcome the presumption set forth in the preceding sentence.

(*b*) *Circumstances indicating absence of understanding.* Examples of circumstances which would be evidence that there was no understanding at the time of original issue to redeem the obligation before maturity are—

(*1*) The issue price and term of the obligation appear to be reasonable, taking into account the interest rate, if any, on the obligation, for a corporation in the financial condition of the issuer at the time of issue.

(*2*) The original purchaser and the issuer are not related within the meaning of section 267(b) and have not engaged in transactions with each other (other than concerning the obligation).

(*3*) The original purchaser is not related within the meaning of section 267(b) to any of the officers or directors of the issuer, and he has not engaged in transactions with such officers or directors (other than concerning the obligation).

(*4*) The officers and directors of the issuer at the time of issue of the obligation are different from those in control at the time the obligation is called or the taxpayer disposes of it.

(c) *Gain treated as ordinary income in certain cases; computation.* The amount of gain treated as ordinary income under paragraph (a) (1) or (2) (ii) of this section is computed by multiplying the original issue discount by a fraction, the numerator of which is the number of full months the obligation was held by the holder and the denominator of which is the number of full months from the date of original issue to the date specified as the redemption date at maturity. (See paragraph (b) (3) of this section for definition of "date of original issue".) The period that the obligation was held by the taxpayer shall include any period that it was held by another person if, under chapter 1 of the Code, for the purpose of determining gain or loss from a sale or exchange, the bond has the same basis, in whole or in part, in the hands of the taxpayer as it would have in the hands of such other person. This computation is illustrated by the following examples:

Example (*1*). An individual purchases a 10-year, 3-percent coupon bond for $900 on original issue on February 1, 1955, and sells it on February 20, 1960, for $940. The redemption price is $1,000. At the time of original issue, there was no intention to call the bond before maturity. The bond has been held by the taxpayer for 60 full months. (The additional days amounting to less than a full month are not taken into account.) The number of complete months from date of issue to date of maturity is 120 (10 years). The fraction 60/120 multiplied by the discount of $100 is equal to $50, which represents the proportionate part of the original issue discount attributable to the period of ownership by the taxpayer. Accordingly, any part of the gain up to $50 will be treated as ordinary income. Therefore, in this case the entire gain of $40 is treated as ordinary income.

Example (*2*). Assume the same facts in the preceding example, except that the selling price of the bond is $970. In this case $50 of the gain of $70 is treated as ordinary income and the balance of $20 is treated as long-term capital gain.

Example (*3*). Assume the same facts as in example (1), except that the selling price of the bond is $800. In this case, the individual has a long-term capital loss of $100.

Example (*4*). Assume the same facts as in example (1), except that the bond is purchased by the second holder February 1, 1960, for $800. The second holder keeps it to the maturity date (February 1, 1965) when it is redeemed for $1,000. Since that holder has held the bond for 60 full months, he will, upon redemption, have $50 in ordinary income and $150 in long-term capital gain.

(d) *Exceptions to the general rule.* Section 1232 (a) (2) (B) provides that section 1232 (a) (2) (A) does not apply (1) to obligations the interest on which is excluded from gross income under section 103 (relating to certain government obligations), or (2) to any holder who purchased an obligation at a premium. For purposes of section 1232 and this section, "premium" means a purchase price which exceeds the stated redemption price of an obligation at its maturity. If, under chapter 1 of the Code, the basis of an obligation in the hands of the holder is the same, in whole or in part, for the purposes of determining gain or loss from a sale or exchange, as the basis of the obligation in the hands of another person who purchased the obligation at a premium, then the holder shall be considered to have purchased

the obligation at a premium. Thus, the donee of an obligation purchased at a premium by the donor will be considered a holder who purchased the obligation at a premium.

(e) *Amounts previously includible in income.* Nothing in section 1232 shall require the inclusion of any amount previously includible in gross income. Thus, if an amount was previously includible in a taxpayer's income on account of obligations issued at a discount and redeemable for fixed amounts increasing at stated intervals, or, under section 818(b), as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 133) (relating to accrual of discount on bonds and other evidences of indebtedness held by life insurance companies), such amount is not again includible in the taxpayer's gross income under section 1232. For example, amounts includible in gross income by a cash receipts and disbursements method taxpayer who has made an election under section 454 (a) or (c) (relating to accounting rules for certain obligations issued at a discount) are not includible in gross income under section 1232. In the case of a gain which would include, under section 1232, an amount considered to be ordinary income and a further amount considered long-term capital gain, any amount to which this paragraph applies is first used to offset the amount considered ordinary income. For example, on January 1, 1955, A purchases a ten-year bond which is redeemable for fixed amounts increasing at stated intervals. At the time of original issue, there was no intention to call the bond before maturity. The purchase price of the bond is $75, which is also the issue price. The stated redemption price at maturity of the bond is $100. A elects to treat the annual increase in the redemption price of the bond as income pursuant to section 454(a). On January 1, 1960, A sells the bond for $90. The total stated increase in the redemption price of the bond which A has reported annually as income for the taxable years 1955 through 1959 is $7. The portion of the original issue discount of $25 attributable to this period is $12.50, computed as follows:

$$\frac{\text{60 (months bond is held by A)}}{\text{120 (months from date of original issue to redemption date)}} \times \$25 \text{ (original issue discount)}$$

However, $7, which represents the annual stated increase taken into income, is offset against the amount of $12.50, leaving $5.50 of the gain from the sale to be treated as ordinary income.

(f) *Record keeping requirements.* In the case of any obligation held by a taxpayer which was issued at an original issue discount after December 31, 1954, the taxpayer shall keep a record of the issue price and issue date upon or with each such obligation (if known to or reasonably ascertainable by him). The issuer (or in the case of obligations first sold to the public through an underwriter or wholesaler, the underwriter or wholesaler) shall mark the issue price and issue date upon every obligation which is issued at an original issue discount after September 26, 1957.

§ 1.1232–4 Obligations with excess coupons detached.

Section 1232(c) provides that if an obligation which is issued at any time with interest coupons—

(a) Is purchased after August 16, 1954, and before January 1, 1958, and the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, or

(b) Is purchased after December 31, 1957, and the purchaser does not receive all the coupons which first become payable after the date of purchase,

any gain on the later sale or other disposition of the obligation by the purchaser (or by a transferee of the purchaser whose basis is determined by reference to the basis of the obligation in the hands of the purchaser) shall be treated as ordinary income to the extent that the fair market value of the obligation (determined as of the time of the purchase) with coupons attached exceeds the purchase price. If both the preceding sentence and section 1232(a)(2)(A) apply with respect to the gain realized on the retirement or other disposition of an obligation, then section 1232(a)(2)(A) shall apply only with respect to that part of the gain to which the preceding sentence does not apply. For example, a $100 bond which sells at $90 with all its coupons attached is purchased by A for $80 with 3 years' coupons detached. Three years later, A sells the bond for $92. The first $10 of the $12 profit is taxable as ordinary income. The remaining $2 gain is taxable either as ordinary income or as long-term capital gain, depending upon the application of section 1232(a)(2)(A). Pursuant to section 7851 (a) (1) (C), the regulations prescribed in this section shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, although such years are subject to the Internal Revenue Code of 1939.

§ 1.1233 Statutory provisions; gains and losses from short sales.

SEC. 1233. *Gains and losses from short sales*—(a) *Capital assets.* For purposes of this subtitle, gain or loss from the short sale of property, other than a hedging transaction in commodity futures, shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property, including a commodity future, used to close the short sale constitutes a capital asset in the hands of the taxpayer.

(b) *Short-term gains and holding periods.* If gain or loss from a short sale is considered as gain or loss from the sale or exchange of a capital asset under subsection (a) and if on the date of such short sale substantially identical property has been held by the taxpayer for not more than 6 months (determined without regard to the effect, under paragraph (2) of this subsection, of such short sale on the holding period), or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof—

(1) Any gain on the closing of such short sale shall be considered as a gain on the sale or exchange of a capital asset held for not more than 6 months (notwithstanding the period of time any property used to close such short sale has been held); and

(2) The holding period of such substantially identical property shall be considered to begin (notwithstanding section 1223, relating to the holding period of property) on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of such property, whichever date occurs first. This paragraph shall apply to such substantially identical property in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short. For purposes of this subsection, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale.

(c) *Certain options to sell.* Subsection (b) shall not include an option to sell property at a fixed price acquired on the same day on which the property identified as intended to be used in exercising such option is acquired and which, if exercised, is exercised through the sale of the property so identified. If the option is not exercised the cost of the option shall be added to the basis of the property with which the option is identified. This subsection shall apply only to options acquired after the date of enactment of this title.

(d) *Long-term losses.* If on the date of such short sale substantially identical property has been held by the taxpayer for more than 6 months, any loss on the closing of such short sale shall be considered as a loss on the sale or exchange of a capital asset held for more than 6 months (notwithstanding the period of time any property used to close such short sale has been held, and notwithstanding section 1234).

(e) *Rules for application of section.* (1) Subsection (b) (1) or (d) shall not apply to the gain or loss, respectively, on any quantity of property used to close such short sale which is in excess of the quantity of the substantially identical property referred to in the applicable subsection.

(2) For purposes of subsections (b) and (d)—

(A) The term "property" includes only stocks and securities (including stocks and securities dealt with on a "when issued" basis), and commodity futures, which are capital assets in the hands of the taxpayer;

(B) In the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in 1 calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month; and

(C) In the case of a short sale of property by an individual, the term "taxpayer", in the application of this subsection and subsections (b) and (d), shall be read as "taxpayer or his spouse"; but an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

(3) Where the taxpayer enters into 2 commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on

the same day, subsections (b) and (d) shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other.

(f) *Arbitrage operations in securities.* In the case of a short sale which had been entered into as an arbitrage operation, to which sale the rule of subsection (b) (2) would apply except as otherwise provided in this subsection—

(1) Subsection (b) (2) shall apply first to substantially identical assets acquired for arbitrage operations held at the close of business on the day such sale is made, and only to the extent that the quantity sold short exceeds the substantially identical assets acquired for arbitrage operations held at the close of business on the day such sale is made, shall the holding period of any other such identical assets held by the taxpayer be affected;

(2) In the event that assets acquired for arbitrage operations are disposed of in such manner as to create a net short position in assets acquired for arbitrage operations, such net short position shall be deemed to constitute a short sale made on that day;

(3) For the purpose of paragraphs (1) and (2) of this subsection the taxpayer will be deemed as of the close of any business day to hold property which he is or will be entitled to receive or acquire by virtue of any other asset acquired for arbitrage operations or by virtue of any contract he has entered into an arbitrage operation; and

(4) For the purpose of this subsection arbitrage operations are transactions involving the purchase and sale of assets for the purpose of profiting from a current difference between the price of the asset purchased and the price of the asset sold, and in which the asset purchased, if not identical to the asset sold, is such that by virtue thereof the taxpayer is, or will be, entitled to acquire assets identical to the assets sold. Such operations must be clearly identified by the taxpayer in his records as arbitrage operations on the day of the transaction or as soon thereafter as may be practicable. Assets acquired for arbitrage operations will include stocks and securities and the right to acquire stocks and securities.

[Sec. 1233(f), as amended by sec. 1, Act of August 12, 1955 (Pub. Law 385, 84th Cong., 69 Stat. 717)]

§ 1.1233–1 Gains and losses from short sales.

(a) *General.* (1) For income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale. Whether the recognized gain or loss from a short sale is capital gain or loss or ordinary gain or loss depends upon whether the property so delivered constitutes a capital asset in the hands of the taxpayer.

(2) Thus, if a dealer in securities makes a short sale of X Corporation stock, ordinary gain or loss results on closing of the short sale if the stock used to close the short sale was stock which he held primarily for sale to customers in the ordinary course of his trade or business. If the stock used to close the short sale was a capital asset in his hands, or if the taxpayer in this example was not a dealer, a capital gain or loss would result.

(3) Generally, the period for which a taxpayer holds property delivered to close a short sale determines whether long-term or short-term capital gain or loss results.

(4) Thus, if a taxpayer makes a short sale of shares of stock and covers the short sale by purchasing and delivering shares which he held for not more than six months, the recognized gain or loss would be considered short-term capital gain or loss. If the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

(b) *Hedging transactions.* Gain or loss from a bona fide hedging transaction in commodity futures entered into by flour millers, producers of cloth, operators of grain elevators, etc., for the purpose of their business shall not be considered gain or loss from the sale or exchange of a capital asset. Gain or loss from a short sale of commodity futures which does not qualify as a hedging transaction shall be considered gain or loss from the sale or exchange of a capital asset if the commodity future used to close the short sale constitutes a capital asset in the hands of the taxpayer as explained in paragraph (a) of this section.

(c) *Special short sales*—(1) *General.* Section 1233 provides rules as to the tax consequences of a short sale of property if gain or loss from the short sale is considered as gain or loss from the sale or exchange of a capital asset under section 1233 (a) and paragraph (a) of this section and if, at the time of the short sale or on or before the date of the closing of the short sale, the taxpayer holds property substantially identical to that sold short. The term "property" is defined for purposes of such rules to include only stocks and securities (including stocks and securities dealt with on a "when issued" basis) and commodity futures, which are capital assets in the hands of the taxpayer. Certain restrictions on the application of the section to commodity futures are provided in section 1233 (e) and paragraph (d) (2) of this section. Section 1233 (f) contains special provisions governing the operation of rule (2) in subparagraph (2) of this paragraph in the case of a purchase and short sale of stocks or securities in a transaction qualifying as an arbitrage operation.

(2) *Treatment of special short sales.* The first two rules, which are set forth in section 1233 (b), are applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than 6 months (determined without regard to rule (2), contained in this subparagraph, relating to the holding period) or is acquired by him after the short sale and on or before the date of the closing thereof. These rules are:

Rule (1). Any gain upon the closing of such short sale shall be considered as a gain upon the sale or exchange of a capital asset held for not more than 6 months (notwithstanding the period of time any property used to close such short sale has been held); and

Rule (2). The holding period of such substantially identical property shall be considered to begin (notwithstanding the provisions of section 1223) on the date of the closing of such short sale or on the date of a sale, gift, or other disposition of such property, whichever date occurs first.

(3) *Options to sell.* For the purpose of rule (1) and rule (2) in subparagraph (2) of this paragraph, the acquisition of an option to sell property at a fixed price shall be considered a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale, except that any option to sell property at a fixed price acquired on or after August 17, 1954 (the day after enactment of the Internal Revenue Code of 1954), shall not be considered a short sale and the exercise or failure to exercise such option shall not be considered as the closing of a short sale provided that the option and property identified as intended to be used in its exercise are acquired on the same date. This exception shall not apply, if the option is exercised, unless it is exercised by the sale of the property so identified. In the case of any option not exercised which falls within this exception, the cost of such option shall be added to the basis of the property with which such option is identified. If the option itself does not specifically identify the property intended to be used in exercising the option, then the identification of such property shall be made by appropriate entries in the taxpayer's records within 15 days after the date such property is acquired or before November 17, 1956, whichever expiration date later occurs.

(4) *Treatment of losses.* The third rule, which is set forth in section 1233 (d), is applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than 6 months. This rule is:

Rule (3). Any loss upon the closing of such short sale shall be considered as a loss upon the sale or exchange of a capital asset held for more than six months, notwithstanding the period of time any property used to close such short sale has been held. For the purpose of this rule, the acquisition of an option to sell property at a fixed price is not considered a short sale, and the exercise or failure to exercise such option is not considered as a closing of a short sale.

(5) *Application of rules.* Rules (1) and (3) contained in subparagraphs (2) and (4) of this paragraph do not apply to the gain or loss attributable to so much of the property sold short as exceeds in quantity the substantially identical property referred to in section 1233 (b) and (d), respectively. Except as otherwise provided in section 1233(f), rule (2) in subparagraph (2) of this paragraph applies to the substantially identical property referred to in section 1233(b) in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short. If property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than six months, or is acquired by him after the short sale and on or before the date of the closing thereof, and if property substantially identical to that sold short has been held by the taxpayer on

the date of the short sale for more than six months, all three rules are applicable.

(6) *Examples.* The following examples illustrate the application of these rules to short sales of stock in the case of a taxpayer who makes his return on the basis of the calendar year:

Example (1). A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on July 1, 1955, and closes the short sale on August 2, 1955, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $600 realized upon the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain.

Example (2). A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on July 1, 1955, closes the short sale on August 1, 1955, with 100 shares of X stock purchased on that date at $18 per share, and on August 2, 1955, sells at $18 per share the 100 shares of X stock purchased on February 1, 1955. The $200 loss sustained upon the closing of the short sale is a short-term capital loss to which section 1233 (d) has no application. By application of rule (2) in subparagraph (2) of this paragraph, however, the holding period of the 100 shares of X stock purchased on February 1, 1955, and sold on August 2, 1955 is considered to begin on August 1, 1955, the date of the closing of the short sale. The $800 gain realized upon the sale of such stock is, therefore, a short-term capital gain.

Example (3). A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on September 1, 1955, sells on October 1, 1955, at $18 per share the 100 shares of X stock purchased on February 1, 1955, and closes the short sale on October 1, 1955, with 100 shares of X stock purchased on that date at $18 per share. The $800 gain realized upon the sale of the 100 shares of X stock purchased on February 1, 1955, is a long-term capital gain to which section 1233 (b) has no application. Since A had held 100 shares of X stock on the date of the short sale for more than 6 months, the $200 loss sustained upon the closing of the short sale is, by application of rule (3) in subparagraph (4) of this paragraph, a long-term capital loss. If, instead of purchasing 100 shares of X stock on October 1, 1955, A closed the short sale with the 100 shares of stock purchased on February 1, 1955, the $600 gain realized on the closing of the short sale would be a long-term capital gain to which section 1233 (b) has no application.

Example (4). A sells short 100 shares of X stock at $16 per share on February 1, 1955. He buys 250 shares of X stock on March 1, 1955, at $10 per share and holds the latter stock until September 2, 1955 (more than 6 months), at which time, 100 shares of the 250 shares of X stock are delivered to close the short sale made on February 1, 1955. Since substantially identical property was acquired by A after the short sale and before it was closed, the $600 gain realized on the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain. The holding period of the remaining 150 shares of X stock is not affected by section 1233 since this amount of the substantially identical property exceeds the quantity of the property sold short.

Example (5). A buys 100 shares of X stock at $10 per share on February 1, 1955, buys an additional 100 shares of X stock at $20 per share on July 1, 1955, sells short 100 shares of X stock at $30 per share on September 1, 1955, and closes the short sale on February 1, 1956, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $2,000 realized upon the closing of the short sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain and the holding period of the 100 shares of X stock purchased on July 1, 1955, is considered, by application of rule (2) in subparagraph (2) of this paragraph to begin on February 1, 1956, the date of the closing of the short sale. If, however, the 100 shares of X stock purchased on July 1, 1955, had been used by A to close the short sale, then, since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the gain of $1,000 realized upon the closing of the short sale would be, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233. If, on the other hand, A purchased an additional 100 shares of X stock at $40 per share on February 1, 1956, and used such shares to close the short sale at that time, then, since 100 shares of X stock had been held by A on the date of the short sale for more than 6 months, the loss of $1,000 sustained upon the closing of the short sale would be, by application of rule (3) in subparagraph (4) of this paragraph, a long-term capital loss, and since 100 shares of X stock had been held by A on the date of the short sale for not more than 6 months, the holding period of the 100 shares of X stock purchased on July 1, 1955, would be considered, by application of rule (2) in subparagraph (2) of this paragraph, to begin on February 1, 1956, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233.

Example (6). A buys 100 shares of X preferred stock at $10 per share on February 1, 1955. On July 1, 1955, he enters into a contract to sell 100 shares of XY common stock at $16 per share when, as, and if issued pursuant to a particular plan of reorganization. On August 2, 1955, he receives 100 shares of XY common stock in exchange for the 100 shares of X preferred stock purchased on February 1, 1955, and delivers such common shares in performance of his July 1, 1955, contract. Assume that the exchange of the X preferred stock for the XY common stock is a tax-free exchange pursuant to section 354 (a) (1), and that on the basis of all of the facts and circumstances existing on July 1, 1955, the "when issued" XY common stock is substantially identical to the X preferred stock. Since 100 shares of substantially identical property had been held by A for not more than 6 months on the date of entering into the July 1, 1955, contract of sale, the gain of $600 realized upon the closing of the contract of sale is, by application of rule (1) in subparagraph (2) of this paragraph, a short-term capital gain.

(d) *Other rules for the application of section 1233.*—(1) *Substantially identical property.* The term "substantially identical property" is to be applied according to the facts and circumstances in each case. In general, as applied to stocks or securities, the term has the same meaning as the term "substantially identical stock or securities" used in section 1091, relating to wash sales of stocks or securities. For certain restrictions on the term as applied to commodity futures see subparagraph (2) of this paragraph. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. In certain situations they may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of predecessor and successor corporations are substantially identical property. Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property. Similarly, depending on the facts and circumstances, the term may apply to the stocks and securities to be received in a corporate reorganization or recapitalization, traded in on a when issued basis, as compared with the stocks or securities to be exchanged in such reorganization or recapitalization.

(2) *Commodity futures.* (i) As provided in section 1233 (e) (2) (B), in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in one calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month. For example, commodity futures in May wheat and July wheat are not considered, for the purpose of section 1233, substantially identical property. Similarly, futures in different commodities which are not generally through custom of the trade used as hedges for each other (such as corn and wheat, for example) are not considered substantially identical property. If commodity futures are otherwise substantially identical property, the mere fact that they were procured through different brokers will not remove them from the scope of the term "substantially identical property". Commodity futures procured on different markets may come within the term "substantially identical property" depending upon the facts and circumstances in the case, with the historical similarity in the price movements in the two markets as the primary factor to be considered.

(ii) Section 1233 (e) (3), relating to so-called "arbitrage" transactions in commodity futures, provides that where a taxpayer enters into two commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, section 1233 shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other.

Section 1233 (f), relating to arbitrage operations in stocks or securities, has no application to arbitrage transactions in commodity futures.

(iii) The following example indicates the application of section 1233 to a commodity futures transaction:

Example. A, who makes his return on the basis of the calendar year, on February 1, 1955, enters into a contract through broker X to purchase 10,000 bushels of December wheat on the Chicago market at $2 per bushel. On July 1, 1955, he enters into a contract through broker Y to sell 10,000 bushels of December wheat on the Chicago market at $2.25 per bushel. On August 2, 1955, he closes both transactions at $2.50 per bushel. The $2,500 loss sustained on the closing of the short sale is a short-term capital loss to which section 1233 (d) has no application. By application of rule (2) in paragraph (c)(2) of this section, however, the holding period of the futures contract entered into on February 1, 1955, is considered to begin on August 2, 1955, the date of the closing of the short sale. The $5,000 gain realized upon the closing of such contract is, therefore, a short-term capital gain.

(3) *Husband and wife.* Section 1233 (e) (2) (C) provides that, in the case of a short sale of property by an individual, the term "taxpayer" in the application of subsections (b), (d), and (e) shall be read as "taxpayer or his spouse". Thus, if the spouse of a taxpayer holds or acquires property substantially identical to that sold short by the taxpayer, and other conditions of subsections (b), (d), and (e) are met, then the rules set forth therein are applicable to the same extent as if the taxpayer held or acquired the substantially identical property. For this purpose, an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

§ 1.1234 Statutory provisions; options to buy or sell.

SEC. 1234. *Options to buy or sell*—(a) *Treatment of gain or loss.* Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, a privilege or option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option or privilege relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).

(b) *Special rule for loss attributable to failure to exercise option.* For purposes of subsection (a), if loss is attributable to failure to exercise a privilege or option, the privilege or option shall be deemed to have been sold or exchanged on the day it expired.

(c) *Non-application of section.* This section shall not apply to—

(1) A privilege or option which constitutes property described in paragraph (1) of section 1221;

(2) In the case of gain attributable to the sale or exchange of a privilege or option, any income derived in connection with such privilege or option which, without regard to this section, is treated as other than gain from the sale or exchange of a capital asset;

(3) A loss attributable to failure to exercise an option described in section 1233 (c); or

(4) Gain attributable to the sale or exchange of a privilege or option acquired by the taxpayer before March 1, 1954, if in the hands of the taxpayer such privilege or option is a capital asset.

[Sec. 1234 as amended by sec. 53, Technical Amendments Act 1958 (72 Stat. 1644)]

§ 1.1234–1 Options to buy or sell.

(a) *Sale or exchange*—(1) *Capital assets.* Gain or loss from the sale or exchange of an option (or privilege) to buy or sell property which is (or if acquired would be) a capital asset in the hands of the taxpayer holding the option is considered as gain or loss from the sale or exchange of a capital asset (unless, under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231). The period for which the taxpayer has held the option determines whether the capital gain or loss is short-term or long-term.

(2) *Section 1231 transactions.* Gain or loss from the sale or exchange of an option to buy or sell property is considered a gain or loss subject to the provisions of section 1231 if, had the sale or exchange been of the property subject to the option, held by the taxpayer for the length of time he held the option, the sale or exchange would have been subject to the provisions of section 1231.

(3) *Other property.* Gain or loss from the sale or exchange of an option to buy or sell property which is not (or if acquired would not be) a capital asset in the hands of the taxpayer holding the option is considered ordinary income or loss (unless under the provisions of subparagraph (2) of this paragraph, the gain or loss is subject to the provisions of section 1231).

(b) *Failure to exercise option.* If the holder of an option to buy or sell property incurs a loss on failure to exercise the option, the option is deemed to have been sold or exchanged upon the date that it expired. Any such loss to the holder of an option is treated under the general rule provided in paragraph (a) of this section. Any gain to the grantor of an option arising from the failure of the holder to exercise it is ordinary income.

(c) *Certain options to sell property at a fixed price.* Section 1234 does not apply to a loss on the failure to exercise an option to sell property at a fixed price which is acquired on the same day on which the property identified as intended to be used in exercising the option is acquired. Such a loss is not recognized, but the cost of the option is added to the basis of the property with which it is identified. See section 1233 (c) and the regulations thereunder.

(d) *Dealers in options to buy or sell.* Any gain or loss realized by a dealer in options from the sale or exchange or an option to buy or sell property is considered ordinary income or loss under paragraph (a) (3) of this section. A dealer in options to buy or sell property is considered a dealer in the property subject to the option.

(e) *Other exceptions.* Section 1234 does not apply to gain resulting from the sale or exchange of an option—

(1) To the extent that the gain is in the nature of compensation (see sections 61 and 421, and the regulations thereunder, relating to employee stock options);

(2) If the option is treated as section 306 stock (see section 306 and the regulations thereunder, relating to dispositions of certain stock); or

(3) To the extent that the gain is a distribution of earnings or profits taxable as a dividend (see section 301 and the regulations thereunder, relating to distributions of property).

(4) Acquired by the taxpayer before March 1, 1954, if in the hands of the taxpayer such option is a capital asset (whether or not the property to which the option relates is, or would be if acquired by the taxpayer, a capital asset in the hands of the taxpayer).

(f) *Limitations on effect of section.* Losses to which section 1234 applies are subject to the limitations on losses under sections 165 (c) and 1211 when applicable. Section 1234 does not permit the deduction of any loss which is disallowed under any other provision of law. In addition, section 1234 does not apply to an option to lease property, but does apply to an option to buy or sell a lease. Thus, an option to obtain all the right, title, and interest of a lessee in leased property is subject to the provisions of section 1234, but an option to obtain a sublease from the lessee is not. Furthermore, if section 1234 applies to an option to buy or sell a lease, it is the character the lease itself, if acquired, would have in the hands of the taxpayer, and not the character of the property leased, which determines the treatment of gain or loss experienced by the taxpayer with respect to such an option.

(g) *Examples.* The rules set forth in this section may be illustrated by the following examples:

Example (1). A taxpayer is considering buying a new house for his residence and acquires an option to buy a certain house at a fixed price. Although the property goes up in value, the taxpayer decides he does not want the house for his residence and sells the option for more than he paid for it. The gain which taxpayer realized is a capital gain since the property, if acquired, would have been a capital asset in his hands.

Example (2). Assume the same facts as in example (1), except that the property goes down in value, and the taxpayer decides not to purchase the house. He sells the option at a loss. While this is a capital loss under section 1234, it is not a deductible loss because of the provisions of section 165 (c).

Example (3). A dealer in industrial property acquires an option to buy an industrial site and fails to exercise the option. The loss is an ordinary loss since he would have held the property for sale to customers in the ordinary course of his trade or business if he had acquired it.

§ 1.1235 Statutory provisions; sale or exchange of patents.

SEC. 1235. *Sale or exchange of patents*—(a) *General.* A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(1) Payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) Contingent on the productivity, use, or disposition of the property transferred.

(b) *"Holder" defined.* For purposes of this section, the term "holder" means—

(1) Any individual whose efforts created such property, or

(2) Any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(A) The employer of such creator, nor

(B) Related to such creator (within the meaning of subsection (d)).

(c) *Effective date.* This section shall be applicable with regard to any amounts received, or payments made, pursuant to a transfer described in subsection (a) in any taxable year to which this subtitle applies, regardless of the taxable year in which such transfer occurred.

(d) *Related persons.* Subsection (a) shall not apply to any transfer, directly or indirectly, between persons specified within any one of the paragraphs of section 267(b); except that, in applying section 267(b) and (c) for purposes of this section—

(1) The phrase "25 percent or more" shall be substituted for the phrase "more than 50 percent" each place it appears in section 267(b), and

(2) Paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

(e) *Cross reference.* For special rule relating to non-resident aliens, see section 871(a).

[Sec. 1235 as amended by sec. 54, Technical Amendments Act 1958 (72 Stat. 1644)]

§ 1.1235–1 Sale or exchange of patents.

(a) *General rule.* Section 1235 provides that a transfer (other than by gift, inheritance, or devise) of all substantial rights to a patent, or of an undivided interest in all such rights to a patent, by a holder to a person other than a related person constitutes the sale or exchange of a capital asset held for more than six months, whether or not payments therefor are—

(1) Payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) Contingent on the productivity, use, or disposition of the property transferred.

(b) *Scope of section 1235.* If a transfer is not one described in paragraph (a) of this section, section 1235 shall be disregarded in determining whether or not such transfer is the sale or exchange of a capital asset. For example, a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by section 1235. The tax consequences of such transfers shall be determined under other provisions of the internal revenue laws.

(c) *Special rules*—(1) *Payments for infringement.* If section 1235 applies to the transfer of all substantial rights to a patent (or an undivided interest therein), amounts received in settlement of, or as the award of damages in, a suit for compensatory damages for infringement of the patent shall be considered payments attributable to a transfer to which section 1235 applies to the extent that such amounts relate to the interest transferred. See section 1304 and the regulations thereunder for treatment of compensatory damages for patent infringement.

(2) *Payments to an employee.* Payments received by an employee as compensation for services rendered as an employee under an employment contract requiring the employee to transfer to the employer the rights to any invention by such employee are not attributable to a transfer to which section 1235 applies. However, whether payments received by an employee from his employer (under an employment contract or otherwise) are attributable to the transfer by the employee of all substantial rights to a patent (or an undivided interest therein) or are compensation for services rendered the employer by the employee is a question of fact. In determining which is the case, consideration shall be given not only to all the facts and circumstances of the employment relationship but also to whether the amount of such payments depends upon the production, sale, or use by, or the value to, the employer of the patent rights transferred by the employee. If it is determined that payments are attributable to the transfer of patent rights, and all other requirements under section 1235 are met, such payments shall be treated as proceeds derived from the sale of a patent.

(3) *Successive transfers.* The applicability of section 1235 to transfers of undivided interest in patents, or to successive transfers of such rights, shall be determined separately with respect to each transfer. For example, X, who is a holder, and Y, who is not a holder, transfer their respective two-thirds and one-third undivided interests in a patent to Z. Assume the transfer by X qualifies under section 1235 and that X in a later transfer acquires all the rights with respect to Y's interest, including the rights to payments from Z. One-third of all the payments thereafter received by X from Z are not attributable to a transfer to which section 1235 applies.

(d) *Payor's treatment of payments in a transfer under section 1235.* Payments made by the transferee of patent rights pursuant to a transfer satisfying the requirements of section 1235 are payments of the purchase price for the patent rights and are not the payment of royalties.

(e) *Effective date.* Amounts received or accrued, and payments made or accrued, during any taxable year beginning after December 31, 1953 and ending after August 16, 1954, pursuant to a transfer satisfying the requirements of section 1235, whether such transfer occurred in a taxable year to which the Internal Revenue Code of 1954 applies, or in a year prior thereto, are subject to the provisions of section 1235.

(f) *Nonresident aliens.* For the special rule relating to nonresident aliens who have gains arising from a transfer to which section 1235 applies, see section 871 and the regulations thereunder. For withholding of tax from income of nonresident aliens, see section 1441 and the regulations thereunder.

§ 1.1235–2 Definition of terms.

For the purposes of section 1235 and § 1.1235–1—

(a) *Patent.* The term "patent" means a patent granted under the provisions of title 35 of the United States Code, or any foreign patent granting rights generally similar to those under a United States patent. It is not necessary that the patent or patent application for the invention be in existence if the requirements of section 1235 are otherwise met.

(b) *All substantial rights to a patent.* (1) The term "all substantial rights to a patent" means all rights which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction. A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of all substantial rights to a patent.

(2) Rights which are not considered substantial for purposes of section 1235 may be retained by the holder. Examples of such rights are:

(i) The retention by the transferor of legal title for the purpose of securing performance or payment by the transferee in a transaction involving transfer of an exclusive license to manufacture, use, and sell for the life of the patent;

(ii) The retention by the transferor of rights in the property which are not inconsistent with the passage of ownership, such as the retention of a security interest (such as a vendor's lien), or a reservation in the nature of a condition subsequent (such as a provision for forfeiture on account of nonperformance).

(3) Examples of rights which may or may not be substantial, depending upon the circumstances of the whole transaction in which rights to a patent are transferred, are:

(i) The retention by the transferor of an absolute right to prohibit sublicensing or subassignment by the transferee;

(ii) The failure to convey to the transferee the right to use or to sell the patent property.

(4) The retention of a right to terminate the transfer at will is the retention of a substantial right for the purposes of section 1235.

(c) *Undivided interest.* A person owns an "undivided interest" in all substantial rights to a patent when he owns the same fractional share of each and every substantial right to the patent. It does not include, for example, a right to the income from a patent, or a license limited geographically, or a license which covers some, but not all, of the valuable claims or uses covered by the patent. A transfer limited in duration by the terms of the instrument to a period less than the remaining life of the patent is not a transfer of an undivided interest in all substantial rights to a patent.

(d) *Holder.* (1) The term "holder" means any individual—

(i) Whose efforts created the patent property and who would qualify as the "original and first" inventor, or joint inventor, within the meaning of title 35 of the United States Code, or

(ii) Who has acquired his interest in the patent property in exchange for a consideration paid to the inventor in money or money's worth prior to the actual reduction of the invention to practice (see paragraph (e) of this section), provided that such individual was neither the employer of the inventor nor related to him (see paragraph (f) of this section). The requirement that such individual is neither the employer of the inventor nor related to him must be satisfied at the time when the substantive rights as to the interest to be acquired are determined, and at the time when the consideration in money or money's worth to be paid is definitely fixed. For example, if prior to the actual reduction to practice of an invention an individual who is neither the employer of the inventor nor related to him agrees to pay the inventor a sum of money definitely fixed as to amount in return for an undivided one-half interest in rights to a patent and at a later date, when such individual has become the employer of the inventor, he pays the definitely fixed sum of money pursuant to the earlier agreement, such individual will not be denied the status of a holder because of such employment relationship.

(2) Although a partnership cannot be a holder, each member of a partnership who is an individual may qualify as a holder as to his share of a patent owned by the partnership. For example, if an inventor who is a member of a partnership composed solely of individuals uses partnership property in the development of his invention with the understanding that the patent when issued will become partnership property, each of the inventor's partners during this period would qualify as a holder. If, in this example, the partnership were not composed solely of individuals, nevertheless, each of the individual partners' distributive shares of income attributable to the transfer of all substantial rights to the patent or an undivided interest therein, would be considered proceeds from the sale or exchange of a capital asset held for more than six months.

(3) An individual may qualify as a holder whether or not he is in the business of making inventions or in the business of buying and selling patents.

(e) *Actual reduction to practice.* For the purposes of determining whether an individual is a holder under paragraph (d) of this section, the term "actual reduction to practice" has the same meaning as it does under section 102 (g) of title 35 of the United States Code. Generally, an invention is reduced to actual practice when it has been tested and operated successfully under operating conditions. This may occur either before or after application for a patent but cannot occur later than the earliest time that commercial exploitation of the invention occurs.

(f) *Related person.* (1) The term "related person" means one whose relationship to another person at the time of the transfer is described in section 267 (b), except that the term does not include a brother or sister, whether of the whole or the half blood. Thus, if a holder transfers all his substantial rights to a patent to his brother or sister, or both, such transfer is not to a related person.

(2) If, prior to September 3, 1958, a holder transferred all his substantial rights to a patent to a corporation in which he owned more than 50 percent in value of the outstanding stock, he is considered as having transferred such rights to a related person for the purpose of section 1235. On the other hand, if a holder, prior to September 3, 1958, transferred all his substantial rights to a patent to a corporation in which he owned 50 percent or less in value of the outstanding stock and his brother owned the remaining stock, he is not considered as having transferred such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(3) If, subsequent to September 2, 1958, a holder transfers all his substantial rights to a patent to a corporation in which he owns 25 percent or more in value of the outstanding stock, he is considered as transferring such rights to a related person for the purpose of section 1235. On the other hand if a holder, subsequent to September 2, 1958, transfers all his substantial rights to a patent to a corporation in which he owns less than 25 percent in value of the outstanding stock and his brother owns the remaining stock, he is not considered as transferring such rights to a related person since the brother relationship is to be disregarded for purposes of section 1235.

(4) If a relationship described in section 267 (b) exists independently of family status, the brother-sister exception, described in subparagraphs (1), (2), and (3) of this paragraph, does not apply. Thus, if a holder transfers all his substantial rights to a patent to the fiduciary of a trust of which the holder is the grantor, the holder and the fiduciary are related persons for purposes of section 1235(d). (See section 267(b)(4).) The transfer, therefore, would not qualify under section 1235(a). This result obtains whether or not the fiduciary is the brother or sister of the holder since the disqualifying relationship exists because of the grantor-fiduciary status and not because of family status.

§ 1.1236 Statutory provisions; dealers in securities.

SEC. 1236. *Dealers in securities*—(a) *Capital gains.* Gains by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset unless—

(1) The security was, before the expiration of the 30th day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment or if acquired before October 20, 1951, was so identified before November 20, 1951; and

(2) The security was not, at any time after the expiration of such 30th day, held by such dealer primarily for sale to customers in the ordinary course of his trade or business.

(b) *Ordinary losses.* Loss by a dealer in securities from the sale or exchange of any security shall, except as otherwise provided in section 582 (c), (relating to bond, etc., losses of banks), in no event be considered as loss from the sale or exchange of property which is not a capital asset if at any time after November 19, 1951, the security was clearly identified in the dealer's records as a security held for investment.

(c) *Definition of security.* For purposes of this section, the term "security" means any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

§ 1.1236–1 Dealers in securities.

(a) *Capital gains.* Section 1236(a) provides that gain realized by a dealer in securities from the sale or exchange of a security (as defined in paragraph (c) of this section) shall not be considered as gain from the sale or exchange of a capital asset unless—

(1) The security is, before the expiration of the thirtieth day after the date of its acquisition, clearly identified in the dealer's records as a security held for investment or, if acquired before October 20, 1951, was so identified before November 20, 1951; and

(2) The security is not held by the dealer primarily for sale to customers in the ordinary course of his trade or business at any time after the identification referred to in subparagraph (1) of this paragraph has been made.

Unless both of these requirements are met, the gain is considered as gain from the sale of assets held by the dealer primarily for sale to customers in the course of his business.

(b) *Ordinary losses.* Section 1236 (b) provides that a loss sustained by a dealer in securities from the sale or exchange of a security shall not be considered a loss from the sale or exchange of property which is not a capital asset if at any time after November 19, 1951, the security has been clearly identified in the dealer's records as a security held for investment. Once a security has been identified after November 19, 1951, as being held by the dealer for investment, it shall retain that character for purposes of determining loss on its ultimate disposition, even though at the time of its disposition the dealer holds it primarily for sale to his customers in the ordinary course of his business. However, section 1236 has no application to the extent that section 582 (c) applies to losses of banks.

(c) *Definitions*—(1) *Security.* For the purposes of this section, the term "security" means any share of stock in any corporation, any certificate of stock or interest in any corporation, any note, bond, debenture, or other evidence of indebtedness, or any evidence of any interest in, or right to subscribe to or purchase, any of the foregoing.

(2) *Dealer in securities.* For definition of a "dealer in securities", see the regulations under section 471.

(d) *Identification of security in dealer's records.* (1) A security is clearly identified in the dealer's records as a security held for investment when there is an accounting separation of the security from other securities, as by (i) making appropriate entries in the dealer's books of account to distinguish the security from inventories and to designate it as an investment, and (ii) indicating

with such entries, to the extent feasible, the individual serial number of, or other characteristic symbol imprinted upon, the individual security.

(2) In computing the 30-day period prescribed by section 1236 (a), the first day of the period is the day following the date of acquisition. Thus, in the case of a security acquired on March 18, 1957, the 30-day period expires at midnight on April 17, 1957.

§ 1.1237 Statutory provisions; real property subdivided for sale.

SEC. 1237. *Real property subdivided for sale*—(a) *General.* Any lot or parcel which is part of a tract of real property in the hands of a taxpayer (including corporations only if no shareholder directly or indirectly holds real property for sale to customers in the ordinary course of trade or business and only in the case of property described in the last sentence of subsection (b) (3)) shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale, if

(1) Such tract, or any lot or parcel thereof, had not previously been held by such taxpayer primarily for sale to customers in the ordinary course of trade or business (unless such tract at such previous time would have been covered by this section) and, in the same taxable year in which the sale occurs, such taxpayer does not so hold any other real property; and

(2) No substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer. For purposes of this paragraph, an improvement shall be deemed to be made by the taxpayer if such improvement was made by:

(A) The taxpayer or members of his family (as defined in section 267 (c) (4)), by a corporation controlled by the taxpayer, or by a partnership which included the taxpayer as a partner; or

(B) A lessee, but only if the improvement constitutes income to the taxpayer; or

(C) Federal, State, or local government, or political subdivision thereof, but only if the improvement constitutes an addition to basis for the taxpayer; and

(3) Such lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of 5 years.

(b) *Special rules for application of section*—(1) *Gains.* If more than 5 lots or parcels contained in the same tract of real property are sold or exchanged, gain from any sale or exchange (which occurs in or after the taxable year in which the sixth lot or parcel is sold or exchanged) of any lot or parcel which comes within the provisions of paragraphs (1), (2) and (3) of subsection (a) of this section shall be deemed to be gain from the sale of property held primarily for sale to customers in the ordinary course of the trade or business to the extent of 5 percent of the selling price.

(2) *Expenditures of sale.* For the purpose of computing gain under paragraph (1) of this subsection, expenditures incurred in connection with the sale or exchange of any lot or parcel shall neither be allowed as a deduction in computing taxable income, nor treated as reducing the amount realized on such sale or exchange; but so much of such expenditures as does not exceed the portion of gain deemed under paragraph (1) of this subsection to be gain from the sale of property held primarily for sale to customers in the ordinary course of trade or business shall be so allowed as a deduction, and the remainder, if any, shall be treated as reducing the amount realized on such sale or exchange.

(3) *Necessary improvements.* No improvement shall be deemed a substantial improvement for purposes of subsection (a) if the lot or parcel is held by the taxpayer for a period of 10 years and if:

(A) Such improvement is the building or installation of water, sewer, or drainage facilities or roads (if such improvement would except for this paragraph constitute a substantial improvement);

(B) It is shown to the satisfaction of the Secretary or his delegate that the lot or parcel, the value of which was substantially enhanced by such improvement, would not have been marketable at the prevailing local price for similar building sites without such improvement; and

(C) The taxpayer elects, in accordance with regulations prescribed by the Secretary or his delegate, to make no adjustment to basis of the lot or parcel, or of any other property owned by the taxpayer, on account of the expenditures for such improvements. Such election shall not make any item deductible which would not otherwise be deductible.

The requirements of subparagraphs (B) and (C) shall not apply in the case of property acquired through the foreclosure of a lien thereon which secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of its stock and other consideration and in the case of property adjacent to such property if 80 percent of the real property owned by the taxpayer is property described in the first part of this sentence.

(c) *Tract defined.* For purposes of this section, the term "tract of real property" means a single piece of real property, except that 2 or more pieces of real property shall be considered a tract if at any time they were contiguous in the hands of the taxpayer or if they would be contiguous except for the interposition of a road, street, railroad, stream, or similar property. If, following the sale or exchange of any lot or parcel from a tract of real property, no further sales or exchanges of any other lots or parcels from the remainder of such tract are made for a period of 5 years, such remainder shall be deemed a tract.

(d) *Effective date.* This section shall apply only with respect to sales of property occurring after December 31, 1953, except that, for purposes of subsection (c) (defining tract of real property) and for determining the number of sales under paragraph (1) of subsection (b), all sales of lots and parcels from any tract of real property during the period of 5 years before December 31, 1953, shall be taken into account, except as provided in subsection (c).

[Sec. 1237 as amended by Act of April 27, 1956 (Pub. Law 495, 84th Cong., 70 Stat. 118), sec. 55, Technical Amendments Act 1958 (72 Stat 1645)]

§ 1.1237–1 Real property subdivided for sale.

(a) *General rule*—(1) *Introductory.* This section provides a special rule for determining whether the taxpayer holds real property primarily for sale to customers in the ordinary course of his business under section 1221(1). This rule is to permit taxpayers qualifying under it to sell real estate from a single tract held for investment without the income being treated as ordinary income merely because of subdividing the tract or of active efforts to sell it. The rule is not applicable to dealers in real estate or to corporations, except a corporation making such sales in a taxable year beginning after December 31, 1954, if such corporation qualifies under the provisions of paragraph (c) (5) (iv) of this section.

(2) *When subdividing and selling activities are to be disregarded.* When its conditions are met, section 1237 provides that if there is no other substantial evidence that a taxpayer holds real estate primarily for sale to customers in the ordinary course of his business, he shall not be considered a real estate dealer holding it primarily for sale merely because he has (i) subdivided the tract into lots (or parcels) and (ii) engaged in advertising, promotion, selling activities or the use of sales agents in connection with the sale of lots in such subdivision. Such subdividing and selling activities shall be disregarded in determining the purpose for which the taxpayer held real property sold from a subdivision whenever it is the only substantial evidence indicating that the taxpayer has ever held the real property sold primarily for sale to customers in the ordinary course of his business.

(3) *When subdividing and selling activities are to be taken into account.* When other substantial evidence tends to show that the taxpayer held real property for sale to customers in the ordinary course of his business, his activities in connection with the subdivision and sale of the property sold shall be taken into account in determining the purpose for which the taxpayer held both the subdivided property and any other real property. For example, such other evidence may consist of the taxpayer's selling activities in connection with other property in prior years during which he was engaged in subdividing or selling activities with respect to the subdivided tract, his intention in prior years (or at the time of acquiring the property subdivided) to hold the tract primarily for sale in his business, his subdivision of other tracts in the same year, his holding other real property for sale to customers in the same year, or his construction of a permanent real estate office which he could use in selling other real property. On the other hand, if the only evidence of the taxpayer's purpose in holding real property consisted of not more than one of the following, in the year in question, such fact would not be considered substantial other evidence:

(i) Holding a real estate dealer's license;

(ii) Selling other real property which was clearly investment property;

(iii) Acting as a salesman for a real estate dealer, but without any financial interest in the business; or

(iv) Mere ownership of other vacant real property without engaging in any selling activity whatsoever with respect to it.

If more than one of the above exists, the circumstances may or may not constitute substantial evidence that the taxpayer held real property for sale in his business, depending upon the particular facts in each case.

(4) *Section 1237 not exclusive.* (i) The rule in section 1237 is not exclusive in its application. Section 1237 has no application in determining whether or not real property is held by a taxpayer primarily for sale in his business if any requirement under the section is not met. Also, even though the conditions of section 1237 are met, the rules of section 1237 are not applicable if without regard to section 1237 the real property sold would not have been considered real property held primarily for sale to customers in the ordinary course of his business. Thus, the district director may at all times conclude from convincing evidence that the taxpayer held the real property solely as an investment. Furthermore, whether or not the conditions of section 1237 are met, the section has no application to losses realized upon the sale of realty from subdivided property.

(ii) If, owing solely to the application of section 1237, the real property sold is deemed not to have been held primarily for sale in the ordinary course of business, any gain realized upon such sale shall be treated as ordinary income to the extent provided in section 1237 (b) (1) and (2) and paragraph (e) of this section. Any additional gain realized upon the sale shall be treated as gain arising from the sale of a capital asset or, if the circumstances so indicate, as gain arising from the sale of real property used in the trade or business as defined in section 1231 (b) (1). For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(5) *Principal conditions of qualification.* Before section 1237 applies, the taxpayer must meet three basic conditions, more fully explained later: He cannot have held any part of the tract at any time previously for sale in the ordinary course of his business, nor in the year of sale held any other real estate for sale to customers; he cannot make substantial improvements on the tract which increase the value of the lot sold substantially; and he must have owned the property 5 years, unless he inherited it. However, the taxpayer may make certain improvements if they are necessary to make the property marketable if he elects neither to add their cost to the basis of the property, or of any other property, nor to deduct the cost as an expense, and he has held the property at least 10 years. If the requirements of section 1237 are met, gain (but not more than 5 percent of the selling price of each lot) shall be treated as ordinary income in and after the year in which the sixth lot or parcel is sold.

(b) *Disqualification arising from holding real property primarily for sale*— (1) *General rule.* Section 1237 does not apply to any transaction if the taxpayer either—

(i) Held the lot sold (or the tract of which it was a part) primarily for sale in the ordinary course of his business in a prior year, or

(ii) Holds other real property primarily for sale in the ordinary course of his business in the same year in which such lot is sold.

Where either of these elements is present, section 1237 shall be disregarded in determining the proper treatment of any gain arising from such sale.

(2) *Method of applying general rule.* For purposes of this paragraph, in determining whether the lot sold was held primarily for sale in the ordinary course of business in a prior year, the principles of section 1237 shall be applied, whether or not section 1237 was effective for such prior year, if the sale of the lot occurs after December 31, 1953, or, in the case of a corporation meeting the requirements of paragraph (c) (5) (iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Whether, on the other hand, the taxpayer holds other real property for sale in the ordinary course of his business in the same year such lot was sold shall be determined without regard to the application of section 1237 to such other real property.

(3) *Attribution rules with respect to the holding of property.* The taxpayer is considered as holding property which he owns individually, jointly, or as a member of a partnership. He is not generally considered as holding property owned by members of his family, an estate or trust, or a corporation. See, however, paragraph (c) (5) (iv) (c) of this section for an exception to this rule. The purpose for which a prior owner held the lot or tract, or his activities, are immaterial except to the extent they indicate the purpose for which the taxpayer has held the lot or tract. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held. The principles of this subparagraph may be illustrated by the following example:

Example. A dealer in real property held a tract of land for sale to customers in the ordinary course of his business for 5 years. He then made a gift of it to his son. As a result of the operation of section 1223 (2) the son will have held the property for the period of time required by section 1237. However, he will not qualify for the benefits of section 1237 because, there being no evidence to the contrary, the circumstances involved establish that the son holds the property for sale to customers, as did his father.

(c) *Disqualification arising from substantial improvements* — (1) *General rule.* Section 1237 will not apply if the taxpayer or certain others make improvements on the tract which are substantial and which substantially increase the value of the lot sold. Certain improvements are not substantial within the meaning of section 1237 (a) (2) if they are necessary to make the lot marketable at the prevailing local price and meet the other conditions of section 1237 (b) (3). See subparagraph (5) of this paragraph.

(2) *Improvements made or deemed to be made by the taxpayer.* Certain improvements made by the taxpayer or made under a contract of sale between the taxpayer and the buyer make section 1237 inapplicable.

(i) For the purposes of section 1237 (a) (2) the taxpayer is deemed to have made any improvements on the tract while he held it which are made by:

(*a*) The taxpayer's whole or half brothers and sisters, spouse, ancestors, and lineal descendants.

(*b*) A corporation controlled by the taxpayer. A corporation is controlled by the taxpayer if he controls, as the result of direct ownership, constructive ownership, or otherwise, more than 50 percent of the corporation's voting stock.

(*c*) A partnership of which the taxpayer was a member at the time the improvements were made.

(*d*) A lessee if the improvement takes the place of a payment of rental income. See section 109 and the regulations thereunder.

(*e*) A Federal, State, or local government, or political subdivision thereof, if the improvement results in an increase in the taxpayer's basis for the property, as it would, for example, from a special tax assessment for paving streets.

(ii) The principles of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. A held a tract of land for 3 years during which he made substantial improvements thereon which substantially enhanced the value of every lot on the tract. A then made a gift of the tract to his son. The son made no further improvements on the tract, but held it for 3 years and then sold several lots therefrom. The son is not entitled to the benefits of section 1237 since under section 1237 (a) (2) he is deemed to have made the substantial improvements made by his father, and under section 1223 (2) he is treated as having held the property for the period during which his father held it. Thus, the disqualifying improvements are deemed to have been made by the son while the tract was held by him. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(iii) The taxpayer is also charged with making any improvements made pursuant to a contract of sale entered into between the taxpayer and the buyer. Therefore, the buyer, as well as the taxpayer, may make improvements which prevent the application of section 1237.

(*a*) If a contract of sale obligates either the taxpayer or the buyer to make a substantial improvement which would substantially increase the value of the lot, the taxpayer may not claim the application of section 1237 unless the obligation to improve the lot ceases (for any reason other than that the improvement has been made) before or within the period, prescribed by section 6511, within which the taxpayer may file a claim for credit or refund of an overpayment of his tax on the gain from the sale of the lot. The following example illustrates this rule:

Example. In 1956, A sells several lots from a tract he has subdivided for sale. Section 1237 would apply to the sales of these lots except that in the contract of sale, A agreed to install sewers, hard surface roads, and other utilities which would increase the value of the lots substantially. If in 1957, instead of requiring the improvements, the buyer releases A from this obligation, A may then claim the application of section 1237 to the sale of lots in 1956 in computing his income tax for 1956, since the period of limitations in which A may file a claim for credit or refund of an overpayment of his 1956 income tax has not expired.

(*b*) An improvement is made pursuant to a contract if the contract imposes an

obligation on either party to make the improvement, but not if the contract merely places restrictions on the improvements, if any, either party may make. The following example illustrates this rule:

Example. B sells several lots from a tract which he has subdivided. Each contract of sale prohibits the purchaser from building any structure on his lot except a personal residence costing $15,000 or more. Even if the purchasers build such residences, that does not preclude B from applying section 1237 to the sales of such lots, since the contracts did not obligate the purchasers to make any improvements.

(iv) Improvements made by a bona fide lessee (other than as rent) or by others not described in section 1237 (a) (2) do not preclude the use of section 1237.

(3) *When improvements substantially enhance the value of the lot sold.* Before a substantial improvement will preclude the use of section 1237, it must substantially enhance the value of the lot sold.

(i) The increase in value to be considered is only the increase attributable to the improvement or improvements. Other changes in the market price of the lot, not arising from improvements made by the taxpayer, shall be disregarded. The difference between the value of the lot, including improvements, when the improvement has been completed and an appraisal of its value if unimproved at that time, will disclose the value added by the improvements.

(ii) Whether improvements have substantially increased the value of a lot depends upon the circumstances in each case. If improvements increase the value of a lot by 10 percent or less, such increase will not be considered as substantial, but if the value of the lot is increased by more than 10 percent, then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial.

(iii) Improvement may increase the value of some lots in a tract without equally affecting other lots in the same tract. Only the lots whose value was substantially increased are ineligible for application of the rule established by section 1237.

(4) *When an improvement is substantial.* To prevent the application of section 1237, the improvement itself must be substantial in character. Among the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. On the other hand a temporary structure used as a field office, surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements.

(5) *Special rules relating to substantial improvements.* Under certain conditions a taxpayer, including a corporation to which subdivision (iv) of this subparagraph applies, may obtain the benefits of section 1237 whether or not substantial improvements have been made. In addition, an individual taxpayer may, under certain circumstances, elect to have substantial improvements treated as necessary and not substantial.

(i) *When an improvement is not considered substantial.* An improvement will not be considered substantial if all of the following conditions are met:

(*a*) The taxpayer has held the property for 10 years. The full 10-year period must elapse, whether or not the taxpayer inherited the property. Although the taxpayer must hold the property 10 years, he need not hold it for 10 years after subdividing it. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(*b*) The improvement consists of the building or installation of water, sewer, or drainage facilities (either surface, sub-surface, or both) or roads, including hard surface roads, curbs, and gutters.

(*c*) The district director with whom the taxpayer must file his return is satisfied that, without such improvement, the lot sold would not have brought the prevailing local price for similar building sites.

(*d*) The taxpayer elects, as provided in subdivision (iii) of this subparagraph, not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense.

(ii) *Meaning of "similar building site".* A "similar building site" is any real property in the immediate vicinity whose size, terrain, and other characteristics are comparable to the taxpayer's property. For the purpose of determining whether a tract is marketable at the prevailing local price for similar building sites, the taxpayer shall furnish the district director with sufficient evidence to enable him to compare (*a*) the value of the taxpayer's property in an unimproved state with (*b*) the amount for which similar building sites, improved by the installation of water, sewer, or drainage facilities or roads, have recently been sold, reduced by the present cost of such improvements. Such comparison may be made and expressed in terms of dollars per square foot, dollars per acre, or dollars per front foot, or in any other suitable terms depending upon the practice generally followed by real estate dealers in the taxpayer's locality. The taxpayer shall also furnish evidence, where possible, of the best bona fide offer received for the tract or a lot thereof just before making the improvement, to assist the district director in determining the value of the tract or lot if it had been sold in its unimproved state. The operation of this subdivision and subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (*1*). A has been offered $500 per acre for a tract without roads, water, or sewer facilities which he has owned for 15 years. The adjacent tract has been subdivided and improved with water facilities and hard surface roads, and has sold for $4,000 per acre. The estimated cost of roads and water facilities on the adjacent tract is $2,500 per acre. The prevailing local price for similar building sites in the vicinity would be $1,500 per acre (i. e., $4,000 less $2,500). If A installed roads and water facilities at a cost of $2,500 per acre, his tract would sell for approximately $4,000 per acre. Under section 1237 (b) (3) the installation of roads and water facilities does not constitute a substantial improvement if A elects to disregard the cost of such improvements ($2,500 per acre) in computing his cost or other basis for the lots sold from the tract, and in computing his basis for any other property owned by him.

Example (*2*). Assume the same facts as in example (1) of this subdivision, except that A can obtain $1,600 per acre for his property without improvements. The installation of any substantial improvements would not constitute a necessary improvement under section 1237 (b) (3), since the prevailing local price could have been obtained without any improvement.

Example (*3*). Assume the same facts as in example (1) of this subdivision, except that the adjacent tract has also been improved with sewer facilities, the present cost of which is $1,200 per acre. The installation of the substantial improvements would not constitute a necessary improvement under section 1237 (b) (3) on A's part, since the prevailing local price ($4,000 less the sum of $1,200 plus $2,500, or $300) could have been obtained by A without any improvement.

(iii) *Manner of making election.* The election required by section 1237 (b) (3) (C) shall be made as follows:

(*a*) The taxpayer shall submit:

(*1*) A plat showing the subdivision and all improvements attributable to him.

(*2*) A list of all improvements to the tract, showing:

(*i*) The cost of such improvements.

(*ii*) Which of the improvements, without regard to the election, he considers "substantial" and which he considers not "substantial."

(*iii*) Those improvements which are substantial to which the election is to apply, with a fair allocation of their cost to each lot they affect, and the amount by which they have increased the values of such lots.

(*iv*) The date on which each lot was acquired and its basis for determining gain or loss, exclusive of the cost of any improvements listed in subdivision (*iii*) of this subdivision.

(*3*) A statement that he will neither deduct as an expense nor add to the basis of any lot sold, or of any other property, any portion of the cost of any substantial improvement which substantially increased the value of any lot in the tract and which either he listed pursuant to (*a*) (*2*) (*iii*) of this subdivision or which the district director deems substantial.

(*b*) The election and the information required under (*a*) of this subdivision shall be submitted to the district director—

(*1*) With the taxpayer's income tax return for the taxable year in which the lots subject to the election were sold, or

(*2*) In the case of a return filed prior to August 14, 1957, either with a timely claim for refund, where the benefits of section 1237 have not been claimed on such return, or, independently, before November 13, 1957, where such benefits have been claimed, or

(*3*) If there is an obligation to make disqualifying improvements outstanding when the taxpayer files his return, with a formal claim for refund at the time of the release of the obligation, if it is then still possible to file a timely claim.

(c) Once made, the election as to the necessary improvement costs attributable to any lot sold shall be irrevocable and binding on the taxpayer unless the district director assesses an income tax as to such lot as if it were held for sale in the ordinary course of taxpayer's business. Under such circumstances, in computing gain, the cost or other basis shall be computed without regard to section 1237.

(iv) *Exceptions with respect to "necessary" improvements and certain corporations.* For taxable years beginning after December 31, 1954, individual taxpayers and certain corporations may obtain the benefits of section 1237 without complying with the provisions of subdivisions (i) (c) and (d), (ii), and (iii) of this subparagraph if the requirements of section 1237 are otherwise met and if—

(a) The property in question was acquired by the taxpayer through the foreclosure of a lien thereon,

(b) The lien foreclosed secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) secured the payment of an indebtedness to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of the stock of the corporation and other consideration, and

(c) In the case of a corporate taxpayer, no shareholder of the corporation holds real property for sale to customers in the ordinary course of his trade or business or holds a controlling interest in another corporation which actually so holds real property, or which, but for the application of this subdivision, would be considered to so hold real property.

Thus, in the case of such property, it is not necessary for the taxpayer to satisfy the district director that the property would not have brought the prevailing local price without improvements or to elect not to add the cost of the improvements to his basis. In addition, if 80 percent or more of the real property owned by a taxpayer is property to which this subdivision applies, the requirements of (a) and (b) of this subdivision need not be met with respect to property adjacent to such property which is also owned by the taxpayer.

(d) *Holding period required*—(1) *General rules.* To apply section 1237, the taxpayer must either have inherited the lot sold or have held it for 5 years. Generally, the provisions of section 1223 are applicable in determining the period for which the taxpayer has held the property. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A held a tract of land for 3 years under circumstances otherwise qualifying for section 1237 treatment. He made a gift of the tract to B at a time when the fair market value of the tract exceeded A's basis for the tract. B held the tract for 2 more years under similar circumstances. B then sold 4 lots from the tract. B is entitled to the benefits of section 1237 since under section 1223 (2) he held the lots for 5 years and all the other requirements of section 1237 are met.

Example (2). C purchased all the stock in a corporation in 1955. The corporation purchased an unimproved tract of land in 1957. In 1961 the corporation was liquidated under section 333 and C acquired the tract of land. For purposes of section 1237, C's holding period commenced on the date the corporation actually acquired the land in 1957 and not on the date C purchased the stock.

(2) *Rules relating to property acquired upon death.* If the taxpayer inherited the property there is no 5-year holding period required under section 1237. However, any holding period required by any other provision of the Code, such as section 1222, is nevertheless applicable. For purposes of section 1237, neither the survivor's one-half of community property, nor property acquired by survivorship in a joint tenancy, is property acquired by devise or inheritance. The holding period for the surviving joint tenant begins on the date the property was originally acquired.

(e) *Tax consequences if section 1237 applies*—(1) *Introductory.* Where there is no substantial evidence other than subdivision and related selling activities that real property is held for sale in the ordinary course of taxpayer's business and section 1237 applies, section 1237 (b) (1) provides a special rule for computing taxable gain. For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(2) *Characterization of gain and its relation to selling expenses.* (i) When the taxpayer has sold less than 6 lots or parcels from the same tract up to the end of his taxable year, the entire gain will be capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) In computing the number of lots or parcels sold, two or more contiguous lots sold to a single buyer in a single sale will be counted as only one parcel. The following example illustrates this rule:

Example. A meets all the conditions of section 1237 in subdividing and selling a single tract. In 1956 he sells 4 lots to B, C, D, and E. In the same year F buys 3 adjacent lots. Since A has sold only 5 lots or parcels from the tract, any gain A realizes on the sales will be capital gain.

(ii) If the taxpayer has sold the sixth lot or parcel from the same tract within the taxable year, then the amount, if any, by which 5 percent of the selling price of each lot exceeds the expenses incurred in connection with its sale or exchange, shall, to the extent it represents gain, be ordinary income. Any part of the gain not treated as ordinary income will be treated as capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) Five percent of the selling price of each lot sold from the tract in the taxable year the sixth lot is sold and thereafter is, to the extent it represents gain, considered ordinary income. However, all expenses of sale of the lot are to be deducted first from the 5 percent of the gain which would otherwise be considered ordinary income, and any remainder of such expenses shall reduce the gain upon the sale or exchange which would otherwise be considered capital gain. Such expenses cannot be deducted as ordinary business expenses from other income. The 5-percent rule applies to all lots sold from the tract in the year the sixth lot or parcel is sold. Thus, if the taxpayer sells the first 6 lots of a single tract in one year, 5 percent of the selling price of each lot sold shall be treated as ordinary income and reduced by the selling expenses. On the other hand, if the taxpayer sells the first 3 lots of a single tract in 1955, and the next 3 lots in 1956, only the gain realized from the sales made in 1956 shall be so treated. For the effect of a 5-year interval between sales, see paragraph (g) (2) of this section. The operation of this subdivision may be illustrated by the following examples:

Example (1). Assume the selling price of the sixth lot of a tract is $10,000, the basis of the lot in the hands of the taxpayer is $5,000, and the expenses of sale are $750. The amount of gain realized by the taxpayer is $4,250, of which the amount of ordinary income attributable to the sale is zero, computed as follows:

Selling price		$10,000
Basis		5,000
Excess over basis		5,000
5 percent of selling price	$500	
Expenses of sale	750	
Amount of grain realized treated as ordinary income		0
Excess over basis		5,000
5 percent of selling price	$500	
Excess of expenses over 5 percent of selling price	250	
		750
Amount of gain realized from sale of property not held for sale in ordinary course of business		4,250

Example (2). Assume the same facts as in Example (1), except that the expenses of sale of such sixth lot are $300. The amount of gain realized by the taxpayer is $4,700, of which the amount of ordinary income attributable to the sale is $200, computed as follows:

Selling price		$10,000
Basis		5,000
Excess over basis		5,000
5 percent of selling price	$500	
Expenses of sale	300	
Amount of gain realized treated as ordinary income		200
Excess over basis		5,000
5 percent of selling price	$500	
Excess of expenses over 5 percent of selling price	0	
		500
Amount of gain realized from sale of property not held for sale in ordinary course of business		4,500

(iii) In the case of an exchange, the term "selling price" shall mean the fair market value of property received plus any sum of money received in exchange for the lot. See section 1031 for those exchanges in which no gain is recognized. For the purpose of subsections (b) and (c) of section 1237 and paragraphs (e) and (g) of this section, an exchange shall be treated as a sale or exchange whether or not gain or loss is recognized with respect to such exchange.

(f) *Relationship of section 1237 and section 1231.* Application of section 1237 to a sale of real property may, in some cases, result in the property being treated as real property used in the trade

or business, as described in section 1231 (b) (1). Thus, assuming section 1237 is otherwise applicable, if the lot sold would be considered property described in section 1231 (b) (1) except for the fact that the taxpayer subdivided the tract of which it was a part, then evidence of such subdivision and connected sales activities shall be disregarded and the lot sold shall be considered real property used in the trade or business. Under such circumstances, any gain or loss realized from the sale shall be treated as gain or loss arising from the sale of real property used in the trade or business.

(g) *Definition of "tract"*—(1) *Aggregation of properties.* For the purposes of section 1237, the term "tract" means either (i) a single piece of real property or (ii) two or more pieces of real property if they were contiguous at any time while held by the taxpayer, or would have been contiguous but for the interposition of a road, street, railroad, stream, or similar property. Properties are contiguous if their boundaries meet at one or more points. The single piece of contiguous properties need not have been conveyed by a single deed. The taxpayer may have assembled them over a period of time and may hold them separately, jointly, or as a partner, or in any combination of such forms of ownership.

(2) *When a subdivision will be considered a new tract.* If the taxpayer sells or exchanges no lots from the tract for a period of 5 years after the sale or exchange of at least 1 lot in the tract, then the remainder of the tract shall be deemed a new tract for the purpose of counting the number of lots sold from the same tract under section 1237 (b) (1). The pieces in the new tract need not be contiguous. The 5-year period is measured between the dates of the sales or exchanges.

(h) *Effective date.* This section shall apply only to gain realized on sales made after December 31, 1953, or, in the case of a person meeting the requirements of paragraph (c) (5) (iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Pursuant to section 7851 (a) (1) (C), the regulations prescribed in this section (other than subdivision (iv) of paragraph (c) (5)) shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and to taxable years beginning after December 31, 1953, and ending before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939. Irrespective of whether the taxable year involved is subject to the Internal Revenue Code of 1939 or the Internal Revenue Code of 1954, sales or exchanges made before January 1, 1954, shall be taken into account to determine whether: (1) No sales or exchanges have been made for 5 years, under section 1237(c), and (2) more than 5 lots or parcels have been sold or exchanged from the same tract, under Section 1237(b) (1). Thus, if the taxpayer sold 5 lots from a single tract in 1950, and another lot is sold in 1954, the lot sold in 1954 constitutes the "sixth lot" sold from the original tract. On the other hand, if the first 5 lots were sold in 1948, the sale made in 1954 shall be deemed to have been made from a new tract.

§ 1.1238 Statutory provisions; amortization in excess of depreciation.

SEC. 1238. *Amortization in excess of depreciation.* Gain from the sale or exchange of property, to the extent that the adjusted basis of such property is less than its adjusted basis determined without regard to section 168 (relating to amortization deduction of emergency facilities), shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

§ 1.1238–1 Amortization in excess of depreciation.

(a) *In general.* Section 1238 provides that if a taxpayer is entitled to a deduction for amortization of an emergency facility under section 168, and if the facility is later sold or exchanged, any gain realized shall be considered as ordinary income to the extent that the amortization deduction exceeds normal depreciation. Thus, under section 1238 gain from a sale or exchange of property shall be considered as ordinary income to the extent that its adjusted basis is less than its adjusted basis would be if it were determined without regard to section 168. If an entire facility is certified under section 168 (e), the taxpayer may use allowances for depreciation based on any rate and method which would have been proper if the basis of the facility were not subject to amortization under section 168, in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. If only a portion of a facility is certified under section 168 (e), allowances for depreciation based on the rate and method properly used with respect to the uncertified part of the facility are used in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. The principles of this paragraph may be illustrated by the following examples:

Example (1). On December 31, 1954, a taxpayer making his income tax returns on a calendar year basis acquires at a cost of $20,000 an emergency facility (used in his business) 50 percent of the adjusted basis of which has been certified under section 168 (e). The facility would normally have a useful life of 20 years. Under section 168 the taxpayer elects to begin the 60-month amortization period on January 1, 1955. He takes amortization deductions with respect to the certified portion in the amount of $4,000 for the years 1955 and 1956 (24 months). With respect to the uncertified portion, the straight line method of depreciation is used and a deduction for depreciation in the amount of $1,000 is claimed and allowed for the years 1955 and 1956 (2 years at $500). On December 31, 1956, he sells the facility for $19,000. The adjusted basis of the certified portion on that date is $6,000 ($10,000 cost, less $4,000 amortization). Without regard to section 168, and using the rate and method the taxpayer properly applied to the uncertified portion of the facility, the adjusted basis of the certified portion on December 31, 1956, would be $9,000 ($10,000 cost, less $1,000 depreciation). The difference between the facility's actual adjusted basis ($15,000) and its adjusted basis determined without regard to section 168 ($18,000), is $3,000. Accordingly, $3,000 of the $4,000 gain on the sale of the facility ($19,000 sale price, less $15,000 adjusted basis) is treated as ordinary income and the remaining $1,000 gain is subject to the provisions of section 1231.

Example (2). Assume that the entire facility in example (1) had been certified under section 168 (e) and that, therefore, the adjusted basis of the facility on December 31, 1956, is $12,000. Assume further that the taxpayer adopts straight line depreciation as a proper method of depreciation for determining the adjusted basis of the facility without regard to section 168. Thus, the adjusted basis, without regard to section 168, would be $18,000. This amount is $6,000 more than the $12,000 adjusted basis under section 168. Hence, $6,000 of the $7,000 gain on the sale of the facility ($19,000 sale price less $12,000 adjusted basis) is treated as ordinary income, and the remaining $1,000 gain is subject to the provisions of section 1231.

(b) *Substituted basis.* If a taxpayer acquires other property in an exchange for an emergency facility with respect to which amortization deductions have been allowed or allowable, and if the basis in his hands of the other property is determined by reference to the basis of the emergency facility, then the basis of the other property is determined with regard to section 168, and therefore the provisions of section 1238 apply with respect to gain realized on a subsequent sale or exchange of the other property. The provisions of section 1238 also apply to gain realized on the sale or exchange of an emergency facility (or other property acquired, as described in the preceding sentence, in exchange for an emergency facility) by a taxpayer in whose hands the basis of the facility (or other property) is determined by reference to its basis in the hands of another person to whom deductions were allowable or allowed with respect to the facility under section 168.

§ 1.1239 Statutory provisions; gain from sale of certain property between spouses or between an individual and a controlled corporation.

SEC. 1239. *Gain from sale of certain property between spouses or between an individual and a controlled corporation*—(a) *Treatment of gain as ordinary income.* In the case of a sale or exchange, directly or indirectly, of property described in subsection (b)—

(1) Between a husband and wife; or

(2) Between an individual and a corporation more than 80 percent in value of the outstanding stock of which is owned by such individual, his spouse, and his minor children and minor grandchildren;

any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(b) *Section applicable only to sales or exchanges of depreciable property.* This section shall apply only in the case of a sale or exchange by a transferor of property which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 167.

(c) *Section not applicable with respect to sales or exchanges made on or before May 3, 1951.* This section shall apply only in the case of a sale or exchange made after May 3, 1951.

[Sec. 1239 as amended by sec. 56, Technical Amendments Act 1958 (72 Stat. 1645)]

§ 1.1239–1 Gain from sale or exchange of certain property between spouses or between an individual and a controlled corporation.

Section 1239 provides in general that any gain from the sale or exchange of depreciable property between a husband and wife or between an individual and a controlled corporation shall be treated as ordinary income. Thus, any gain recognized to the transferor from a sale or exchange after May 3, 1951, directly or indirectly, between a husband and wife or between an individual and a controlled corporation, of property which, in the hands of the transferee, is property of a character subject to an allowance for depreciation provided in section 167 (including such property on which a deduction for amortization is allowable under section 168 or 169) shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. For the purpose of section 1239, a corporation is controlled when more than 80 percent in value of all outstanding stock of the corporation is beneficially owned by the taxpayer, his spouse, and his minor children and minor grandchildren. For the purpose of this section, the terms "children" and "grandchildren" include legally adopted children and their children. The provisions of section 1239 (a) (2) are applicable whether property is transferred from a corporation to a shareholder or from a shareholder to a corporation.

§ 1.1240 Statutory provisions; taxability to employee of termination payments.

SEC. 1240. *Taxability to employee of termination payments.* Amounts received from the assignment or release by an employee, after more than 20 years' employment, of all his rights to receive, after termination of his employment and for a period of not less than 5 years (or for a period ending with his death), a percentage of future profits or receipts of his employer shall be considered an amount received from the sale or exchange of a capital asset held for more than 6 months if—

(1) Such rights were included in the terms of the employment of such employee for not less than 12 years,

(2) Such rights were included in the terms of the employment of such employee before the date of enactment of this title, and

(3) The total of the amounts received for such assignment or release is received in one taxable year and after the termination of such employment.

§ 1.1240–1 Capital gains treatment of certain termination payments.

Any amounts received by an employee for the assignment or release of all his rights to receive, after termination of his employment and for a period of not less than five years or for a period ending with his death, a percentage of the profits or receipts of his employer attributable to a time subsequent to such termination, are considered received from the sale or exchange of a capital asset held for more than six months if the following requirements are met:

(a) The employee was employed by the employer, in whose future profits or receipts the employee had an interest, for a period of more than 20 years before the assignment or release by the employee of his rights in such future profits or receipts,

(b) The full rights of the employee to the percentage of the future profits or receipts of such employer, which rights are the subject of the assignment or release, were incorporated in the terms of the contract of employment between the employee and the employer for a period of at least 12 years, and were so incorporated before August 16, 1954,

(c) The assignment or release was made after the termination of the employee's employment with such employer,

(d) The assignment or release conveyed all the rights of the employee in the future profits or receipts of such employer and conveyed no other rights of the employee, and

(e) The total amount to which the employee became entitled pursuant to the assignment or release was received by the employee after the termination of his employment with such employer and in one taxable year of the employee.

The requirement that the assignment or release be made after the termination of the employee's employment contemplates a complete and bona fide termination of the relationship of employer and employee. This requires more than a mere termination of such relationship under the particular contract or contracts of employment pursuant to which the employee acquired his rights in the future profits or receipts of the employer. The contract need not expressly provide that the employee shall share in the future profits or receipts of the employer for a minimum period of five years. However, if the contract does not expressly so provide and the assignment or release is made before the expiration of five years following the termination of employment, the terms of the contract considered in conjunction with the facts in the particular situation must establish that the rights of the employee to a percentage of future profits or receipts, in all probability, will extend to a period of not less than five years from the date of termination of employment or for a period ending with his death. Section 1240 has application only to an assignment or release made by the employee who acquired the right to a percentage of future profits or receipts of the employer, and has no application to amounts received other than as payment for assignment or release of such right. Section 1240 has no effect upon the determination of the income tax of the employer making the payment to the employee.

§ 1.1241 Statutory provisions; cancellation of lease or distributor's agreement.

SEC. 1241. *Cancellation of lease or distributor's agreement.* Amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), shall be considered as amounts received in exchange for such lease or agreement.

§ 1.1241–1 Cancellation of lease or distributor's agreement.

(a) *In general.* Section 1241 provides that proceeds received by lessees or distributors from the cancellation of leases or of certain distributorship agreements are considered as amounts received in exchange therefor. Section 1241 applies to leases of both real and personal property. Distributorship agreements to which section 1241 applies are described in paragraph (c) of this section. Section 1241 has no application in determining whether or not a cancellation not qualifying under that section is a sale or exchange. Further, section 1241 has no application in determining whether or not a lease or a distributorship agreement is a capital asset, even though its cancellation qualifies as an exchange under section 1241.

(b) *Definition of "cancellation".* The term "cancellation" of a lease or a distributor's agreement, as used in section 1241, means a termination of all the contractual rights of a lessee or distributor with respect to particular premises or a particular distributorship, other than by the expiration of the lease or agreement in accordance with its terms. A payment made in good faith for a partial cancellation of a lease or a distributorship agreement is recognized as an amount received for cancellation under section 1241 if the cancellation relates to a severable economic unit, such as a portion of the premises covered by a lease, a reduction in the unexpired term of a lease or distributorship agreement, or a distributorship in one of several areas or of one of several products. Payments made for other modifications of leases or distributorship agreements, however, are not recognized as amounts received for cancellation under section 1241.

(c) *Amounts received upon cancellation of a distributorship agreement.* Section 1241 applies to distributorship agreements only if they are for marketing or marketing and servicing of goods. It does not apply to agreements for selling intangible property or for rendering personal services as, for example, agreements establishing insurance agencies or agencies for the brokerage of securities. Further, it applies to a distributorship agreement only if the distributor has made a substantial investment of capital in the distributorship. The substantial capital investment must be reflected in physical assets such as inventories of tangible goods, equipment, machinery, storage facilities, or similar property. An investment is not considered substantial for purposes of section 1241 unless it consists of a significant fraction or more of the facilities for storing, transporting, processing, or otherwise dealing with the goods distributed, or consists of a substantial inventory of such goods. The investment required in the maintenance of an office merely for clerical operations is not considered substantial for purposes of this section. Furthermore, section 1241 shall not apply unless a substantial amount of the capital or assets needed for carrying on the operations of a distributorship are acquired by the distributor and actually used in carrying on the distributorship at some time before the cancellation of the dis-

tributorship agreement. It is immaterial for the purposes of section 1241 whether the distributor acquired the assets used in performing the functions of the distributorship before or after beginning his operations under the distributorship agreement. It is also immaterial whether the distributor is a retailer, wholesaler, jobber, or other type of distributor. The application of this paragraph may be illustrated by the following examples:

Example (1). Taxpayer is a distributor of various food products. He leases a warehouse including cold storage facilities and owns a number of motor trucks. In 1955 he obtains the exclusive rights to market certain frozen food products in his State. The marketing is accomplished by using the warehouse and trucks acquired before he entered into the agreement and entails no additional capital. Payments received upon the cancellation of the agreement are treated under section 1241 as though received upon the sale or exchange of the agreement.

Example (2). Assume that the taxpayer in example (1) entered into an exclusive distributorship agreement with the producer under which the taxpayer merely solicits orders through his staff of salesmen, the goods being shipped direct to the purchasers. Payments received upon the cancellation of the agreement would not be treated under section 1241 as though received upon the sale or exchange of the agreement.

Example (3) Taxpayer is an exclusive distributor for M city of certain frozen food products which he distributes to frozen-food freezer and locker customers. The terms of his distributorship do not make it necessary for him to have any substantial investment in inventory. Taxpayer rents a loading platform for a nominal amount, but has no warehouse space. Orders for goods from customers are consolidated by the taxpayer and forwarded to the producer from time to time. Upon receipt of these goods, taxpayer allocates them to the individual orders of customers and delivers them immediately by truck. Although it would require a fleet of fifteen or twenty trucks to carry out this operation, the distributor uses only one truck of his own and hires cartage companies to deliver the bulk of the merchandise to the customers. Payments received upon the cancellation of the distributorship agreement in such a case would not be considered received upon the sale or exchange of the agreement under section 1241 since the taxpayer does not have facilities for the physical handling of more than a small fraction of the goods involved in carrying on the distributorship and, therefore, does not have a substantial capital investment in the distributorship. On the other hand, if the taxpayer had acquired and used a substantial number of the trucks necessary for the deliveries to his customers, payments received upon the cancellation of the agreement would be considered received in exchange therefor under section 1241.

§ 1.1242 Statutory provisions; losses on small business investment company stock.

SEC. 1242. *Losses on small business investment company stock.* If—

(1) A loss is on stock in a small business investment company operating under the Small Business Investment Act of 1958, and

(2) Such loss would (but for this section) be a loss from the sale or exchange of a capital asset,

then such loss shall be treated as a loss from the sale or exchange of property which is not a capital asset. For purposes of section 172 (relating to the net operating loss deduction) any amount of loss treated by reason of this section as a loss from the sale or exchange of property which is not a capital asset shall be treated as attributable to a trade or business of the taxpayer.

[Sec. 1242 as added by sec. 57, Technical Amendments Act 1958 (72 Stat. 1645)]

§ 1.1242–1 Losses on small business investment company stock.

(a) *In general.* Any taxpayer who sustains a loss for a taxable year beginning after September 2, 1958, as a result of the worthlessness, or from the sale or exchange, of the stock of a small business investment company (whether or not such stock was originally issued to such taxpayer) shall treat such loss as a loss from the sale or exchange of property which is not a capital asset, if at the time of such loss—

(1) The company which issued the stock is licensed to operate as a small business investment company pursuant to regulations promulgated by the Small Business Administration (13 CFR Part 107), and

(2) Such loss would, but for the provisions of section 1242, be a loss from the sale or exchange of a capital asset.

(b) *Treatment of losses for purposes of section 172.* For the purposes of section 172 (relating to the net operating loss deduction), any amount of loss treated by reason of section 1242 as a loss from the sale or exchange of property which is not a capital asset shall be treated as attributable to the trade or business of the taxpayer. Accordingly, the limitation of section 172(d)(4) on the allowance of nonbusiness deductions in computing a net operating loss shall not apply to any loss with respect to the stock of a small business investment company as described in paragraph (a) of this section. See section 172(d) and § 1.172–3.

(c) *Statement to be filed with return.* A taxpayer claiming a deduction for a loss on the stock of a small business investment company shall file with his income tax return a statement containing: The name and address of the small business investment company which issued the stock, the number of shares, basis, and selling price of the stock with respect to which the loss is claimed, the respective dates of purchase and sale of such stock, or the reason for its worthlessness and approximate date thereof. For the rules applicable in determining the worthlessness of securities, see section 165 and the regulations thereunder.

§ 1.1243 Statutory provisions; loss of small business investment company.

SEC. 1243. *Loss of small business investment company.* In the case of a small business investment company operating under the Small Business Investment Act of 1958, if—

(1) A loss is on convertible debentures (including stock received pursuant to the conversion privilege) acquired pursuant to section 304 of the Small Business Investment Act of 1958, and

(2) Such loss would (but for this section) be a loss from the sale or exchange of a capital asset,

then such loss shall be treated as a loss from the sale or exchange of property which is not a capital asset.

[Sec. 1243 as added by sec. 57, Technical Amendments Act 1958 (72 Stat. 1645)]

§ 1.1243–1 Loss of small business investment company.

(a) *In general.* A small business investment company which sustains a loss for a taxable year beginning after September 2, 1958, as a result of the worthlessness, or on the sale or exchange, of the securities of a small business concern (as defined in section 103(5) of the Small Business Investment Act of 1958 (15 U.S.C. 662 (5)) and in 13 CFR 107.–103–1) shall treat such loss as a loss from the sale or exchange of property which is not a capital asset if—

(1) The securities are either the convertible debentures, or the stock issued pursuant to the conversion privilege thereof, acquired in accordance with the provisions of section 304 of the Small Business Investment Act of 1958 (15 U.S.C. 684) and the regulations thereunder,

(2) Such loss would, but for the provisions of section 1243, be a loss from the sale or exchange of a capital asset, and

(3) At the time of the loss, the company is licensed to operate as a small business investment company pursuant to regulations promulgated by the Small Business Administration (13 CFR Part 107).

(b) *Material to be filed with return.* A small business investment company which claims a deduction for a loss on the convertible debentures or stock of a small business concern shall submit with its income tax return a statement that it is a Federal licensee under the Small Business Investment Act of 1958 (15 U.S.C. ch. 14B). The statement shall also set forth: the name and address of the small business concern with respect to whose securities the loss was sustained, the number of shares of stock or the number and denomination of bonds with respect to which the loss is claimed, the basis and selling price thereof, and the respective dates of purchase and sale of the securities, or the reason for their worthlessness and the approximate date thereof. For the rules applicable in determining the worthlessness of securities, see section 165 and the regulations thereunder.

READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

§ 1.1301 Statutory provisions; compensation from an employment.

SEC. 1301. *Compensation from an employment*—(a) *Limitation on tax.* If an individual or partnership—

(1) Engages in an employment as defined in subsection (b); and

(2) The employment covers a period of 36 months or more (from the beginning to the completion of such employment); and

(3) The gross compensation from the employment received or accrued in the taxable year of the individual or partnership is not less than 80 percent of the total compensation from such employment,

then the tax attributable to any part of the compensation which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross

income of such individual ratably over that part of the period which precedes the date of such receipt or accrual.

(b) *Definition of an employment.* For purposes of this section, the term "an employment" means an arrangement or series of arrangements for the performance of personal services by an individual or partnership to effect a particular result, regardless of the number of sources from which compensation therefor is obtained.

(c) *Rule with respect to partners.* An individual who is a member of a partnership receiving or accruing compensation from an employment of the type described in subsection (a) shall be entitled to the benefits of that subsection only if the individual has been a member of the partnership continuously for a period of 36 months or the period of the employment immediately preceding the receipt or accrual. In such a case the tax attributable to the part of the compensation which is includible in the gross income of the individual shall not be greater than the aggregate of the taxes which would have been attributable to that part had it been included in the gross income of the individual ratably over the period in which it was earned or the period during which the individual continuously was a member of the partnership, whichever period is the shorter. For purposes of this subsection, a member of a partnership shall be deemed to have been a member of the partnership for any period, ending immediately prior to becoming such a member, in which he was an employee of such partnership, if during the taxable year he received or accrued compensation attributable to employment by the partnership during such period.

§ 1.1301–1 Introduction.

Part I (section 1301 and following), subchapter Q, chapter 1 of the Code, provides special rules to relieve a taxpayer from the amount of tax which otherwise results when an amount of income which has been earned over a period of years is received or accrued in one taxable year. Because of the graduated income tax rates this so-called bunching of income in one year usually subjects it to a higher rate of tax than would be payable if it had been received or accrued over the several years during which it was earned. The statutory provisions of such part I mitigate the tax consequences of such bunching of income by placing a limit upon the amount of tax to be paid for the taxable year in which such income is received or accrued. In effect, these sections generally treat the income as having been included in gross income ratably over the years (preceding receipt or accrual) in which it was earned. However, these sections have no effect on the income tax liability for prior taxable years; they simply provide a special method of computing the amount of tax for the year of receipt or accrual.

§ 1.1301–2 Compensation from an employment.

(a) *Qualifications for limitation on tax.* If an individual or partnership—

(1) Engages in an employment (as defined in section 1301 (b) and paragraph (b) of this section); and

(2) The employment covers a period of 36 months or more (from the beginning to the completion of such employment); and

(3) The gross compensation from the employment received or accrued in the taxable year of the individual or partnership is not less than 80 percent of the total compensation from such employment,

then the tax attributable to any part of the compensation which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period of the employment which precedes the date of such receipt or accrual. The application of this paragraph may be illustrated by the following examples:

Example (1). A, an individual who makes his income tax returns on a calendar year basis and uses the cash receipts and disbursements method of accounting, began an employment, as defined in section 1301 (b) and paragraph (b) of this section, on February 17, 1951, and completed it on July 1, 1954. A's total compensation from such employment was $9,000, of which he received $1,000 on July 1, 1953, and $8,000 on the completion date. Since the employment covered more than 36 months and the $8,000 received in 1954 was not less than 80 percent of A's total compensation from such employment, he is entitled to the benefits of section 1301 in computing the tax payable with respect to the $8,000 reflected in his 1954 return. Section 1301 does not apply to the $1,000 received in 1953. Under section 1301 (a) the tax attributable to the $8,000 included in A's gross income for 1954 is not greater than the aggregate of the taxes attributable to such amount had it been received ratably over the calendar months included in the period from February 17, 1951, to July 1, 1954. However, if A had received an additional $5,000 in 1955 from such employment, he would not be entitled to the benefits of section 1301 with respect to either the $8,000 or the $5,000, since he would not have received in one taxable year at least 80 percent of the total compensation from such employment.

Example (2). If, in example (1) of this paragraph, A had commenced the employment on March 3, 1954, and completed it on August 22, 1957, and had been paid a total compensation of $10,000 for that employment on July 5, 1956, he would be entitled to the benefits of section 1301. However, the tax attributable to the $10,000 included in A's gross income for 1956 cannot be greater than the aggregate of the taxes attributable to such amount had it been received ratably over the calendar months included in the period from March 3, 1954, to July 5, 1956, the date on which the $10,000 was received.

(b) *Definition of an employment.* (1) (i) The term "an employment" means an arrangement or series of arrangements for the performance of personal services by an individual or partnership to effect a particular result, regardless of the number of sources from which compensation for such services is obtained. Thus, there must be an arrangement, and the arrangement must be for the performance of a particular project. In other words, there must be an understanding for the performance of services to accomplish a particular result. Accordingly, an arrangement to perform general services is not an employment within the meaning of section 1301 either as to any particular project on which services are performed or as to the general services since there is no understanding that the services are to accomplish a particular result.

(ii) Whether an employment exists is a question which must be determined by a consideration of all the facts in each case. The primary factor in making such a determination is what the particular profession, business, or industry would normally consider as a distinct project or result. The statements of the parties and the contracts they make, if any, shall be considered in those cases where the project or result cannot be determined under the preceding sentence.

(iii) To qualify as an employment the services must relate to a particular project, such as a particular law case, and must not consist of a set of unrelated services performed for the same person. Furthermore, the individual steps performed by a taxpayer in connection with his project do not each constitute an employment; the services rendered by the taxpayer with respect to the entire project represent the employment.

(iv) The time when an employment begins and ends, and whether the period over which an employment extends includes conference and study time, depend upon the facts of each case. However, in determining the period over which an employment extends, there shall be included the time during which the efforts of the individual or partnership were unsuccessful in effecting the particular result.

(2) The application of the rules described in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). A was retained by X Corporation to perform general legal services. During the period 1955 through 1960, A performed miscellaneous legal services on numerous unrelated matters, each of which effected a particular result, and some of which extended over a period of more than 36 months. A was compensated by a single payment in 1960. A's services do not constitute an employment either as to the unrelated matters on which he worked or the general services performed over the period 1955 through 1960, since the arrangement was for the performance of services generally and not for the performance of any particular results.

Example (2). B was retained as an attorney by the Y Corporation to perform general legal services. An anti-trust action was brought against Y and, since the defense of such an action was beyond the scope of the agreement to perform general legal services, a separate arrangement was entered into between Y and B, whereby B was to be paid a specified additional amount for defending Y in the anti-trust suit. B's services in connection with such suit represent an employment separate and distinct from his general legal services for Y, and such services were performed pursuant to a separate arrangement.

Example (3). As part of a traffic flow improvement program, the City of Z enters into a contract with C, a civil engineer, under which C agrees to perform services in connection with the construction of a highway bypassing the city, a vehicular tunnel under a river, and an elevated roadway in a congested industrial area of the city. C's compensation for his services with respect to each of these construction projects is fixed in the contract. Since the services performed in connection with each such construction project would normally be viewed by the engineering profession as a

distinct project, C's services in connection with each of these construction projects constitute a separate employment. No contractual arrangement between the parties can operate to change the determination of the projects involved. Regardless of its terms, the contract will be viewed as an arrangement for the performance of services to effect three specifically identifiable results. Thus, the arrangement would constitute three distinct employments, even though the contract might provide for a single lump sum payment to be made only upon completion of all three projects.

Example (4). D entered into an agreement with Z Corporation to direct 5 motion picture productions for it in 5 years. Each of the 5 pictures was to be wholly unrelated to the others as entertainment products for public consumption. D's compensation for his services with respect to each picture was to be a certain percentage of the gross proceeds received from its showing. Each picture would normally be viewed by the motion picture industry as a distinct undertaking or project, and D's services in connection with each picture constitute a separate employment. As in the case of example (3), no contractual arrangement between the parties can operate to change the determination of the projects involved.

Example (5). E, a producer of television programs, entered into a contract with Y Television Network to produce a series of documentary films. While each film produced by E was a complete presentation of the specific subject matter, the entire series of films dealt with such subjects and was presented in such a manner as to identify the series as a unit in the public mind. Production of the films required coordinated planning of the whole series. The entire series of films would normally be viewed by the television industry was a distinct undertaking or project, and, therefore, E's services in connection with production of the series of films constitute a single employment. As in the case of examples (3) and (4), no contractual arrangement between the parties can operate to change the determination of the projects involved.

Example (6). F was appointed trustee of a trust which consisted of income producing and non-income producing property. Under a decree of the state court having jurisdiction over the trust, F was awarded certain commissions with respect to principal and certain commissions with respect to income. The fact that such separate compensation was awarded by the court did not establish that two employments were involved. F's services with respect to the principal and those with respect to the income of the trust were merely integral parts of one employment, i. e., the administration of the trust in its entirety.

Example (7). G was retained and served as legal counsel to the trustees of a trust. He also served as one of the trustees of the trust. G's services in each capacity constituted a separate employment, regardless of whether under the laws of the state having jurisdiction of the trust the services rendered by a trustee as legal counsel are eligible for compensation distinct from those rendered by him as trustee.

Example (8). H, an architect, was employed by the City of Z to draft the plans for, and supervise the construction of, a school building. The building was of a type that is normally both planned by and constructed under the supervision of an architect. His employment consisted of his entire services from the beginning of the preparation of the plans to his completion of supervision of the building's construction. The drafting of the plans and the supervision of the construction were merely interrelated steps in the performance of the entire employment.

Example (9). K, an attorney, received a fee from certain stockholders of corporation X, who employed him to represent them in a stockholders' suit. K also received as compensation for his services in connection with such suit an amount allowed by the court out of the shares of the proceeds of the suit payable to the stockholders of corporation X who were unrepresented by counsel. The fact that K receives compensation from two sources will not cause two employments to exist. For purposes of section 1301 the number of sources from which the compensation is obtained is immaterial in determining the number of employments.

(c) *Allocation of income.* The compensation from an employment is to be treated as if it had been received in equal portions in each of the calendar months (including those of the current taxable year) which fall within the period of employment preceding the receipt or accrual of the compensation. Thus, the portion of the compensation allocable to each taxable year involved in such period of employment is an amount equal to the entire compensation from the employment received or accrued in the current taxable year, divided by the entire number of calendar months included within the part of the period of employment which precedes the date of receipt or accrual of such compensation, and multiplied by the number of such calendar months falling within the particular taxable year. The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, an individual who makes his income tax returns on a calendar year basis and uses the cash receipts and disbursements method of accounting, receives $40,000 on September 30, 1954. This amount is the entire compensation from an employment (as defined in section 1301 (b)) covering a 40-month period beginning on June 1, 1951, and ending on September 30, 1954. $1,000 must be allocated to each of the calendar months included within the period of the employment. Thus, $7,000 is allocated to 1951, $12,000 to 1952, $12,000 to 1953, and $9,000 to 1954.

Example (2). Assume the same facts as in example (1), except that A makes his income tax returns on the basis of a taxable year ended June 30. The $40,000 is allocated as follows: $1,000 to the taxable year ended June 30, 1951, $12,000 each to the taxable years ended June 30, 1952, June 30, 1953, and June 30, 1954, and $3,000 to the taxable year ended June 30, 1955 (the current taxable year).

Example (3). Assume the same facts as in example (1), except that A receives the $40,000 on February 1, 1954 (before completion of the employment), instead of September 30, 1954. In this case, there are 32 calendar months included within the part of the period of the employment which precedes the date the compensation is received. Accordingly, $1,250 ($40,000 divided by 32) must be allocated to each of the calendar months included within the period from June 1, 1951, through January 31, 1954. Thus, $8,750 is allocated to 1951, $15,000 to 1952, $15,000 to 1953, and $1,250 to 1954.

Example (4). B, an individual who makes his income tax returns on a calendar year basis and uses the cash receipts and disbursements method of accounting, is engaged in an employment which covers a 40-month period beginning on May 1, 1951, and ending on August 31, 1954. The total compensation from the employment is $74,000, of which $34,000 is paid to B on March 1, 1954, and $40,000 on August 31, 1954. The $34,000 payment must be allocated to the 34 calendar months included within the part of the period of the employment which precedes the date such payment is received (March 1, 1954). Accordingly, with respect to the $34,000 payment, $8,000 is allocated to 1951, $12,000 to 1952, $12,000 to 1953, and $2,000 to 1954. Since the $40,000 payment was received on the date the employment ended it must be allocated to the 40 calendar months included within the entire period of the employment. Accordingly, with respect to such payment, $8,000 is allocated to 1951, $12,000 to 1952, $12,000 to 1953, and $8,000 to 1954. The entire compensation of $74,000 will therefore be allocated as follows: $16,000 to 1951, $24,000 to 1952, $24,000 to 1953, and $10,000 to 1954.

Example (5). C, an individual who makes his income tax returns on a calendar year basis and uses the cash receipts and disbursements method of accounting, is engaged in an employment which covers a 36-month period beginning on February 1, 1954, and ending on January 31, 1957. The total compensation from the employment of $36,000 is paid to C on June 1, 1957. In this case, there are 36 months in the period of the employment which precede the date of receipt of the $36,000 by C. The months of February through May 1957, are not part of the period of employment and therefore no income is to be allocated to those months. Accordingly, the $36,000 is allocated as follows: $11,000 to 1954, $12,000 to 1955, $12,000 to 1956, and $1,000 to 1957.

(d) *Computation of tax*—(1) *Steps of computation.* The following computation shall be made in order to determine whether the limitation on tax prescribed in section 1301 (a) and paragraph (a) of this section applies to compensation from an employment received or accrued in a taxable year:

(i) Compute the tax for the current taxable year by including in the gross income of such year the compensation from an employment received or accrued in such year.

(ii) Compute the tax for the current taxable year without such inclusion.

(iii) Compute the tax attributable to the compensation from an employment allocated to each of the taxable years in accordance with paragraph (c) of this section. The amount of the tax attributable to the compensation from the employment so allocated is the difference between the tax for each such year computed with the inclusion in gross income of each year of the allocable portion of such compensation and the tax for each year computed without such inclusion.

(iv) The tax for the current taxable year shall be the lesser of (*a*) the tax for the current taxable year as computed under subdivision (i) of this subparagraph, or (*b*) the tax for such year as computed under subdivision (ii) of this subparagraph, plus the aggregate of the taxes attributable to the allocated compensation as computed under subdivision (iii) of this subparagraph.

(2) *Effect of allocation of income on items based on amount of income and with respect to a net operating loss or a capital loss carryover.* (i) In computing the tax for any taxable year under this paragraph, any item which depends upon the amount of gross income, adjusted gross income, or taxable income shall be recomputed to take into consideration the amount of compensation allocated to such year (or from such year in the case of the current

taxable year). For example, if by allocating $1,000 of compensation to 1955, adjusted gross income for 1955 is increased from $5,000 to $6,000, then the general limitation on allowable charitable deductions under section 170 (b) (1) (B) is increased from $1,000 to $1,200 and the amount of the nondeductible medical expenses under section 213 is increased from $150 to $180.

(ii) In computing the tax attributable to the compensation from an employment under this paragraph for any taxable year to or from which compensation is allocated, the effect of amounts of compensation allocated to any taxable year (or from the current taxable year) with respect to a net operating loss carryback or carryover or a capital loss carryover, shall be taken into account. Moreover, in determining the amount of tax attributable to such compensation, a computation shall also be made for any taxable year to which no amount of compensation is allocated but which is affected by a net operating loss carryback or carryover or by a capital loss carryover determined by reference to a taxable year to which amounts are so allocated and which net operating loss carryback or carryover or capital loss carryover is reduced or increased by such amounts so allocated. See subparagraph (3) (iv) (*d*) and (*e*) of this paragraph.

(3) *Example.* The computations described in subparagraph (1) of this paragraph may be illustrated by the following example: On January 1, 1952, A, unmarried, was retained as an attorney in an anti-trust suit. This employment continued until June 30, 1955, when the action was terminated and A received a fee of $84,000 as total compensation for his services. Since all the requirements of section 1301 are met with respect to the $84,000, the following tax results will occur, assuming that A's net income (or loss) for the years 1951, 1952, 1953 and his taxable income from 1954 and 1955 were as follows: 1951, $20,600 (which reflects a net operating loss carryback from 1952); 1952, net operating loss $2,000; 1953, $50,600; 1954, $32,000; $1955, $100,000 ($16,000 plus the $84,000 fee).

(i) Allocation of fee to period of employment:

1955 (6 months)	$12,000
1954 (12 months)	24,000
1953 (12 months)	24,000
1952 (12 months)	24,000

(ii) Tax for 1955 computed by including the $84,000 fee in gross income: $67,320.

(iii) Tax for 1955, computed without including the $84,000 fee in gross income: $5,200.

(iv) Taxes attributable to the $84,000 fee allocated to the various taxable years:

	Prior to allocation under sec. 1301		Under sec. 1301
(*a*) Tax attributable to 1955:			
Taxable income			$28,000 ($16,000+$12,000)
Tax		$11,980	11,980
Less		5,200	
Amount of tax attributable to 1955 under sec. 1301			6,780
(*b*) Tax attributable to 1954:			
Taxable income	$32,000		56,000
Tax	14,460		31,320
		31,320	
Less		14,460	
Section 1301 increase attributable to 1954			16,860
(*c*) Tax attributable to 1953:			
Net income	50,600		74,600
Less: Personal exemption	600		600
	50,000		74,000
Tax	28,916		47,936
		47,936	
Less		28,916	
Section 1301 increase attributable to 1953			19,020

(*d*) Tax attributable to 1952:			
Net income	($2,000 net operating loss).		$22,000
Less: Personal exemption			600
			21,400
Tax and section 1301 increase attributable to 1952			8,984
(*e*) Tax attributable to 1951:			
Net income	$20,600		22,600
Less: Personal exemption	600		600
	20,000		22,000
Tax	7,396		8,536
		$8,536	
Less		7,396	
Section 1301 increase attributable to 1951			1,140
(*f*) Aggregate of taxes resulting from allocation of compensation under section 1301:			
1955			6,780
1954			16,860
1953			19,020
1952			8,984
1951			1,140
			52,784

(v) Tax for 1955 under section 1301: $57,984.

Since the tax for 1955 computed without including the $84,000 fee in gross income ($5,200), plus the aggregate of taxes attributable to the allocation of such fee over the period of employment ($52,784) equals $57,984, which is a lesser sum than $67,320 (the amount of tax for 1955 computed by including the entire fee in income for 1955), $57,984 is the amount of tax for 1955 under the provisions of section 1301.

(4) *Compensation received from several employments allocated to same period.* If an individual computes his income tax under section 1301 for a particular taxable year and in a subsequent taxable year receives or accrues compensation from another employment, the period of which coincides to any extent with the period covered by the employment involved in the previous taxable year, such individual must, in availing himself of section 1301 for such subsequent taxable year, take into consideration the fact that he has previously allocated compensation to all or a part of the period covered by the employment later compensated. The same principle is applicable where income entitled to the benefits of other sections in part I, subchapter Q, chapter 1 of the Code, is allocated to a year to which other income entitled to the benefits of the sections in such part I had previously been allocated. For example, an individual commenced an employment on January 1, 1950, and completed it on December 31, 1954, at which time he received $60,000 as total compensation therefrom. In connection with his return for 1954, he allocated $1,000 to each of 60 calendar months included within the period of the employment and determined his income tax under the provisions of section 1301. He also commenced a second employment on January 1, 1952, and completed it on December 31, 1955, at which time he received total compensation of $48,000. In determining whether the limitation on tax prescribed in section 1301(a) is applicable for the calendar year 1955, he must, in connection with allocating $1,000 to each of the 48 calendar months included within the period of such employment and computing the tax attributable thereto, also include in his income for the years 1952, 1953, and 1954, the amount of $12,000 previously allocated to each of such years in connection with his return for the calendar year 1954.

(e) *Rules with respect to partners—* (1) *Qualifications for limitations on tax.* An individual who is a member of a partnership receiving or accruing compensation from an employment of the type described in section 1301 (a) shall be entitled to the benefits of section 1301 only if: (i) He has been a member of the partnership continuously for a period of 36 months immediately preceding the receipt or accrual of such compensation by the partnership, or (ii) he has been a member of the partnership

continuously for the period of the employment immediately preceding such receipt or accrual. It is immaterial whether the individual actually rendered services with respect to the employment to which the compensation is attributable.

(2) *Limitation on tax.* (i) If a partner qualifies under section 1301 (c) and subparagraph (1) of this paragraph for the benefits of section 1301 with respect to a share of partnership income includible in his gross income, the tax attributable to such share shall not be greater than the aggregate of the taxes which would have been attributable to such share had it been included in the gross income of the partner ratably over (*a*) the period in which it was earned immediately preceding the receipt or accrual of the compensation by the partnership, or (*b*) the period during which the individual continuously was a member of the partnership immediately preceding such receipt or accrual, whichever is the shorter period.

(ii) If (*a*) a partnership receives or accrues compensation from an employment of the type described in section 1301 (a) and the period of such employment immediately preceding the date of receipt or accrual is less than 36 months, and (*b*) if any individual has been a member of such partnership continuously for such period, then such individual shall be entitled to allocate his share of the compensation over such period.

(iii) If an individual has been a member of a partnership continuously for a period of at least 36 months immediately preceding the receipt or accrual of compensation from an employment of the type described in section 1301 (a), but such individual has not been a member of the partnership for the total period during which such compensation was earned by the partnership, the allocation of such individual's share of the compensation is limited to the period during which he was continuously a member of the partnership.

(iv) For purposes of section 1301 a partner who has retired under local law will nevertheless be treated as a partner until his interest in the compensation of the partnership from an employment has terminated, but only if such partner would have satisfied the employment requirement of section 1301 (c) if the partnership had received or accrued compensation from such employment on the date of his retirement. In such a case the retired partner shall be entitled to allocate his share of the compensation only over the period of employment preceding his retirement and during which he was a member of the partnership.

(v) The provisions of this paragraph may be illustrated by the following examples:

Example (1). A became a member of the ABC partnership on June 1, 1950. The partnership, which is on the calendar year basis, began an employment on June 1, 1952, and completed it on July 1, 1955. On June 1, 1954, the partnership had received $24,000 as total compensation from such employment. A's $6,000 share of such compensation was included in his gross income for 1954. Since the $24,000 payment was from an employment of the type described in section 1301 (a) and since A had been a member of the partnership continuously for more than 36 months at the date of the receipt of the payment, A is entitled to allocate his $8,000 share over the period in which the income was earned prior to the date of its receipt by the partnership. Thus, for purposes of making the tentative tax computation, A must allocate the $8,000 ratably over the period from June 1, 1952, through May 31, 1954.

Example (2). Assume the same facts as in example (1) of this subdivision, except that A retires from the partnership on July 1, 1954. Such retirement is immaterial for purposes of section 1301; the tax consequences would be the same as in example (1) of this subdivision for the reasons therein set forth.

Example (3). A became a member of the ABC partnership on February 1, 1953. The partnership began an employment on July 1, 1953, and completed it on July 1, 1956. The partnership received $24,000 as compensation from such employment on January 1, 1955. The $24,000 payment was at least 80 percent of the partnership's total compensation from the employment. A included his $8,000 share in his gross income for 1955. Since the employment was of the type described in section 1301 (a) and since A was a member of the partnership continuously for the period of the employment immediately preceding the receipt of the payment, A is entitled to the benefits of section 1301 (a) with respect to his share, even though he had not been a partner for 36 months at the time of the receipt of the compensation. The period over which his share must be allocated for purposes of computing the tentative tax is July 1, 1953, through December 31, 1954.

Example (4). Assume the same facts as in example (3), except that the employment is completed on February 1, 1956. In such case A would not be entitled to the benefits of section 1301 (a), since the employment by the partnership did not cover a period of 36 months or more from its beginning to its completion.

Example (5). The ABC partnership began an employment on June 1, 1952. D became a member of the partnership on June 1, 1955. On June 1, 1957, the partnership received $30,000 as compensation from the employment. D's share of this payment included in his gross income for 1957 was $5,000. The employment terminated on June 1, 1959. The $30,000 payment was at least 80 percent of the total compensation from the employment. D is not entitled to the benefits of section 1301 since he was neither a member of the partnership continuously for a period of 36 months immediately preceding the receipt of the payment by the partnership, nor was he a member of the partnership continuously for the period of employment immediately preceding such receipt.

Example (6). The AB partnership began an employment on February 1, 1955. On February 1, 1957, after the employment had been in progress for two years, C joined the partnership. The employment was completed on July 31, 1960, and covered a period of 66 calendar months. The total compensation from the employment was $198,000 and was received on August 1, 1960, each partner's share amounting to $66,000. A and B are entitled to allocate their shares of the compensation over the full period of the employment, that is, over the 66 calendar months from February 1, 1955, through July 31, 1960. However, C can allocate his share only over a 42-month period extending from February 1, 1957, through July 31, 1960, the period during which he was continuously a member of the partnership. The shares of the total compensation received by A and B are allocable in the amount of $1,000 per month over 66 months, while C must allocate his share at the rate of $1,571.43 per month over 42 months.

Example (7). The ABC partnership began an employment on February 1, 1955. On July 31, 1957, after the employment had been in progress for 30 months, B retired from the partnership. The employment was completed on July 31, 1960, and covered a period of 66 calendar months. The total compensation from the employment was $180,000 and was received on August 1, 1960. Pursuant to the terms of the partnership agreement, A and C each received $75,000, while B received $30,000 as his share. A and C are entitled to allocate their shares of the compensation over the full period of the employment, that is, over the 66 calendar months from February 1, 1955, through July 31, 1960. Since under the terms of the partnership agreement B retained an interest in the compensation from the employment when he retired from the partnership, B will be treated as a partner and be entitled to allocate his $30,000 share over the 30 months of the period of employment preceding his retirement.

(3) *Individual engaged in an employment who becomes a member of a partnership which continues with such employment.* If an individual begins an employment in an individual capacity and later becomes a member of a partnership which continues with such employment, the employment shall be considered, with respect to such individual, as one employment covering both the period during which a portion of the employment was performed by such individual in his capacity as such and the period during which a portion of the employment was performed by the partnership. However, with respect to the other members of the partnership, the period of the employment is limited to the period of the employment performed by the partnership. For example, A, an individual, begins an employment for the X Company on June 1, 1952. On January 1, 1953, A forms a partnership with B and C. The partnership continues with the employment for the X Company and completes it on June 1, 1955, at which time the partnership receives $25,000 as total compensation for the services rendered on the employment. A is entitled to the benefits of section 1301 with respect to his share of the $25,000 and can allocate it over the period June 1, 1952, through May 31, 1955, but B and C are not entitled to such benefits. If, however, the partnership had completed the employment on January 1, 1956, and had received the $25,000 on that date, all three partners would be entitled to section 1301 benefits. A would allocate his share over the period June 1, 1952, through December 31, 1955, whereas B and C would allocate their shares over the period January 1, 1953, through December 31, 1955. Furthermore, if the employment had been completed on January 1, 1956, but the $25,000 had been received by the partnership on January 1, 1955, all partners would be entitled to section 1301 benefits; A allocating his share over the period June 1, 1952, through December 31, 1954, and B and C allocating their shares over the period January 1, 1953, through December 31, 1954.

(4) *Period of allocation where income received by a partner who was formerly an employee.* Where a member of a

partnership who was formerly an employee of such partnership includes in his gross income a part of the compensation received or accrued by the partnership from an employment of the type described in section 1301 (a), he shall be deemed to have been a member of such partnership for the period during which he was an employee ending immediately prior to his becoming such a member. It is immaterial for purposes of this paragraph whether such an individual, as an employee, actually rendered services with respect to the employment to which such compensation is attributable. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A, an individual, became an employee of the XYZ law partnership on June 1, 1952, and a member of the partnership on June 1, 1956. The partnership commenced an employment on June 1, 1954, and completed it on June 1, 1958, at which time it received a payment of $50,000, which satisfied all of the requirements of section 1301 (a). A's share of the $50,000 payment includible in his gross income for 1958 was $5,000. For purposes of section 1301 (c), A is deemed to have been a partner for the period June 1, 1954, through May 31, 1958, and the amount of $5,000 must be allocated ratably over the period June 1, 1954, through May 31, 1958.

Example (2). Assume the same facts as in example (1), except that on June 1, 1955, A left the employ of the partnership and returned on January 1, 1956. In such a case, A is a partner for the purposes of section 1301 for the period January 1, 1956, to June 1, 1958. Under such circumstances, A would not qualify for the benefits of section 1301 (a), since he was not a member of the partnership continuously for the period of 36 months immediately preceding receipt by the partnership of the compensation from the employment, nor was he a member of the partnership continuously for the period of employment immediately preceding the receipt of the compensation by the partnership.

(5) *Effect of withdrawal of a partner or termination of a partnership.* The withdrawal of a partner from a partnership or the termination of a partnership will not bring an employment to an end with respect to any partner who continues to participate in such employment either in his individual capacity or as a partner in a partnership which continues with such employment. For example, partnership AB began an employment on January 1, 1955. On January 1, 1957, B sold his interest to C under such circumstances as to cause the partnership to terminate under section 708 (b) (1). However, partnership AC continued with the employment and completed it on January 1, 1959, at which time the partnership received $100,000 as total compensation for the employment. Since A had an interest in the employment as a partner continuously for a period of 48 months he is entitled to the benefits of section 1301 with respect to his share of the compensation from the employment. C does not qualify, however, since he participated in the employment as a member of a partnership for a period of less than 36 months.

(6) *Effective date.* Section 1301 (c) and this paragraph shall apply only to amounts received or accrued after March 1, 1954. Pursuant to section 7851 (a) (1) (C), the regulations prescribed in this paragraph shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and to taxable years beginning after December 31, 1953, and ending before August 17, 1954, although such years are generally subject to the Internal Revenue Code of 1939. Notwithstanding any other provision of the Internal Revenue Code of 1954, section 107 of the Internal Revenue Code of 1939 shall apply to amounts received or accrued as a partner on or before March 1, 1954, and to the computation of tax on amounts received or accrued on or before March 1, 1954.

§ 1.1302 Statutory provisions; income from an invention or artistic work.

SEC. 1302. *Income from an invention or artistic work*—(a) *Limitation on tax.* If—

(1) An individual includes in gross income amounts in respect of a particular invention or artistic work created by the individual; and

(2) The work on the invention or the artistic work covered a period of 24 months or more (from the beginning to the completion thereof); and

(3) The amounts in respect of the invention or the artistic work includible in gross income for the taxable year are not less than 80 percent of the gross income in respect of such invention or artistic work in the taxable year plus the gross income therefrom in previous taxable years and the 12 months immediately succeeding the close of the taxable year,

then the tax attributable to the part of such gross income of the taxable year which is not taxable as a gain from the sale or exchange of a capital asset held for more than 6 months shall not be greater than the aggregate of the taxes attributable to such part had it been received ratably over, in the case of an invention, that part of the period preceding the close of the taxable year or 60 months, whichever is shorter, or, in the case of an artistic work, that part of the period preceding the close of the taxable year but not more than 36 months.

(b) *Definitions.* For purposes of this section—

(1) *Invention.* The term "invention" means a patent covering an invention of the individual.

(2) *Artistic work.* The term "artistic work" means a literary, musical, or artistic composition or a copyright covering a literary, musical, or artistic composition.

§ 1.1302–1 Income from an invention or artistic work.

(a) *Qualifications for limitation on tax.* (1) The tax attributable to amounts included in gross income by an individual in respect of a particular invention or artistic work which he created shall be limited in accordance with the provisions of paragraph (c) of this section, provided:

(i) The work upon the invention or artistic work covered a period of 24 months or more (from the beginning to the completion thereof), and

(ii) The amounts includible in gross income of the individual for the taxable year from such invention or artistic work are not less than 80 percent of the gross income therefrom in the taxable year, the preceding taxable years, and the 12 months immediately succeeding the close of the taxable year.

(2) That part of the gross income from such artistic work or invention which is taxable as a gain from the sale or exchange of a capital asset held for more than 6 months is excluded from the benefits of section 1302.

(3) For the purpose of determining the tax which would be attributable to gain on the sale or exchange of an artistic work had such gain been received ratably in any prior taxable year, such gain shall be treated as gain from the sale or exchange of property which is not a capital asset.

(b) *Definitions*—(1) *Invention.* For purposes of section 1302 and this section, the term "invention" means a patent covering an invention of the individual.

(2) *Artistic work.* For purposes of section 1302 and this section, the term "artistic work" means a literary, musical, or artistic composition or a copyright covering a literary, musical, or artistic composition.

(c) *Limitation on tax*—(1) *Rule.* When amounts includible in gross income qualify under paragraph (a) of this section, the tax attributable thereto in the taxable year shall not be greater than the aggregate of the taxes attributable thereto had such amounts been received ratably over the period for allocating the income in accordance with subparagraph (2) of this paragraph.

(2) *Allocation of income.* The period for allocating the income shall end with the close of the taxable year in which the amounts qualifying under paragraph (a) of this section are received or accrued, and the length of such period shall equal the lesser of—

(i) The part of the period of work which precedes the close of such taxable year, or

(ii) A period of 60 calendar months in the case of an invention or 36 calendar months in the case of an artistic work.

The gross income from the invention or artistic work is to be treated as if it had been received in equal portions in each of the calendar months which fall within the allocation period. The portion of the gross income from the invention or artistic work allocable to each taxable year involved in the allocation period is an amount equal to the entire amount of gross income from the invention or artistic work received or accrued in the current taxable year, divided by the entire number of calendar months included within the allocation period and multiplied by the number of such calendar months falling within the particular taxable year. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A, an individual who makes his returns on a calendar year basis and uses the cash receipts and disbursements method of accounting, received $36,000 (taxable as ordinary income) on October 1, 1954, in full payment for a musical composition. A commenced work on this composition on July 10, 1950, and completed it on January 29, 1955. Although the period of work covers 55 calendar months, allocations may be made to only the last 36 calendar months included within the part of the period of work which precedes the close of 1954 (the current taxable year). Therefore, $1,000 ($36,000 divided by 36) must be allocated to each of the 36 calendar months preceding January 1, 1955. Accordingly, $12,000 is allocated to

1952, $12,000 to 1953, and $12,000 to 1954 (the current taxable year).

Example (2). Assume the same facts as in example (1), except that A received $54,000 (taxable as ordinary income) for a patent covering an invention of his. In this case, allocations must be made to each of the 54 calendar months included within the part of the period of work which precedes the close of 1954 (the current taxable year). Therefore, $1,000 ($54,000 divided by 54) must be allocated to each of the 54 calendar months preceding January 1, 1955. Accordingly, $6,000 is allocated to 1950 and $12,000 is allocated to each of the years 1951, 1952, 1953, and 1954.

Example (3). Assume the same facts as in example (1), except that the period of work was commenced by A on July 1, 1953, and completed on September 1, 1956. Although the period of work covers 38 calendar months, allocations may be made to only the 18 calendar months which are included within the part of the period of work which precedes the close of 1954 (the current taxable year). Therefore, $2,000 ($36,000 divided by 18) must be allocated to each of the 18 calendar months preceding January 1, 1955. Accordingly, $12,000 is allocated to 1953 and $24,000 to 1954.

Example (4). B, an individual who makes his return on a calendar year basis and uses the cash receipts and disbursements method of accounting, received $36,000 (taxable as ordinary income) on October 1, 1956, in full payment for a musical composition. B commenced work on this composition on March 1, 1950, and completed it on March 1, 1953. The amount received may be allocated over a 36-month period ending with the close of the taxable year in which received. Such amount cannot be allocated over the 36-month period during which B actually worked on the composition. Therefore, $1,000 ($36,000 divided by 36) must be allocated to each of the 36 calendar months preceding January 1, 1957. Accordingly, $12,000 is allocated to 1954, $12,000 to 1955, and $12,000 to 1956.

(d) *Computation of tax*—(1) *Steps of computation.* The following computation shall be made in order to determine whether the limitation on tax prescribed in section 1302 (a) and paragraph (c) of this section applies to income from an invention or artistic work:

(i) Compute the tax for the current taxable year by including in the gross income of such year the amount of gross income from the invention or artistic work received or accrued in such year.

(ii) Compute the tax for the current taxable year without such inclusion.

(iii) Compute the tax attributable to the gross income from the invention or artistic work allocated to each of the taxable years in accordance with paragraph (c) (2) of this section. The amount of the tax attributable to the gross income from the invention or artistic work so allocated is the difference between the tax for each such year computed with the inclusion in gross income of each year of the allocable portion of the gross income from the invention or artistic work and the tax for each such year computed without such inclusion.

(iv) The tax for the current taxable year shall be the lesser of (*a*) the tax for the current taxable year as computed under subdivision (i) of this subparagraph, or (*b*) the tax for such year as computed under subdivision (ii) of this subparagraph, plus the aggregate of the taxes attributable to the allocated gross income from an invention or artistic work as computed under subdivision (iii) of this subparagraph.

(2) For effect of allocation of income on items based on amount of income and with respect to a net operating loss or a capital loss carryover, see paragraph (d) (2) of § 1.1301–2.

(3) See paragraph (d) (4) of § 1.1301–2 for the computations which are necessary when an amount of gross income from an invention or artistic work is allocated to a period to which there has also been allocated other income entitled to the benefits of part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

§ 1.1303 Statutory provisions; income from back pay.

SEC. 1303. *Income from back pay*—(a) *Limitation on tax.* If the amount of the back pay received or accrued by an individual during the taxable year exceeds 15 percent of the gross income of the individual for such year, the part of the tax attributable to the inclusion of such back pay in gross income for the taxable year shall not be greater than the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for the taxable years to which such portions are respectively attributable, as determined under regulations prescribed by the Secretary or his delegate.

(b) *Definition of back pay.* For purposes of this section, the term "back pay" means amounts includible in gross income under this subtitle which are one of the following—

(1) Remuneration, including wages, salaries, retirement pay, and other similar compensation, which is received or accrued during the taxable year by an employee for services performed before the taxable year for his employer and which would have been paid before the taxable year except for the intervention of one of the following events:

(A) Bankruptcy or receivership of the employer;

(B) Dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings;

(C) If the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or

(D) Any other event determined to be similar in nature under regulations prescribed by the Secretary or his delegate.

(2) Wages or salaries which are received or accrued during the taxable year by an employee for services performed before the taxable year for his employer and which constitute retroactive wage or salary increases ordered, recommended, or approved by any Federal or State agency, and made retroactive to any period before the taxable year.

(3) Payments which are received or accrued during the taxable year as the result of an alleged violation by an employer of any State or Federal law relating to labor standards or practices, and which are determined under regulations prescribed by the Secretary or his delegate to be attributable to a prior taxable year.

§ 1.1303–1 Income from back pay.

(a) *Qualifications for limitation on tax.* If the amount of "back pay", as defined in section 1303(b) and paragraph (b) of this section, received or accrued by an individual during the taxable year exceeds 15 percent of the individual's gross income for such year, the part of the tax attributable to the inclusion of such back pay in gross income for the taxable year shall not be greater than the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for the taxable years to which such portions are respectively attributable. The computation of this limitation on tax shall be made in accordance with the provisions of paragraph (d) of this section.

(b) *Definition of back pay*—(1) *Remuneration delayed because of certain events.* "Back pay" means remuneration including wages, salaries, pensions, retirement pay, and other similar compensation, received or accrued during the taxable year and includible in gross income by an employee for services performed prior to the taxable year for his employer and which would have been paid prior to the taxable year but for the intervention of any one of the following events:

(i) Bankruptcy or receivership of the employer;

(ii) Dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings;

(iii) If the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or

(iv) Any other event determined to be similar in nature under this subparagraph. An event will be considered similar in nature to those events specified in subdivisions (i), (ii), and (iii) of this subparagraph only if the circumstances are unusual, if they are of the type specified therein, if they operate to defer payment of the remuneration for the services performed, and if payment, except for such circumstances, would have been made prior to the taxable year in which received or accrued.

For the purposes of section 1303 and this section, the term "back pay" does not include remuneration which is deemed to be constructively received in the taxable year or years in which the services were performed, remuneration paid in the current year in accordance with the usual practice or custom of the employer even though received in respect of services performed in a prior year or years, additional compensation for past services where there was no prior agreement or legal obligation to pay such additional compensation, or any amount which is not includible in gross income under subtitle A of the Code.

(2) *Retroactive wage and salary increases.* "Back pay" also includes retroactive wage or salary increases received or accrued during a taxable year by an employee for services performed in a prior taxable year which have been ordered, recommended, or approved by any Federal or State agency such as, but not limited to, boards authorized by the Railway Labor Act, as amended (45 U. S. C. ch 8), comparable State organizations, and United States and State courts.

(3) *Payments resulting from alleged employer violation of certain laws.* "Back pay" also includes payments which are received or accrued during the taxable year as a result of an alleged violation by an employer of sections 6 and 7 of the Fair Labor Standards Act of 1938, as amended (29 U. S. C. 206, 207), and which are made retroactive to any period prior to the taxable year and payments which are received or accrued during the taxable year arising out of an alleged violation by an employer of any State or Federal law relating to labor standards or practices, such as payments received to effectuate the policies of the National Labor Relations Act, as amended (29 U.S.C. ch. 7, subch. II).

(c) *Allocation of back pay to prior years.* For the purpose of determining under section 1303 (a) the particular taxable year or years to which the back pay is attributable and, if such back pay is attributable to more than one taxable year, the amount thereof which is attributable to each of such taxable years, the following rules will be applicable:

(1) Back pay, as defined in section 1303 (b) (1), shall be deemed to be attributable to a particular taxable year to the extent that it would have been paid in such year except for the intervention of one of the events described in section 1303 (b) (1).

(2) Back pay, as defined in section 1303 (b) (2), shall be deemed to be attributable to a particular taxable year to the extent that it would have been paid in such year had the wage or salary increase described in section 1303 (b) (2) been actually put into effect on the date to which it was first made retroactive.

(3) Back pay, as defined in section 1303 (b) (3), shall be deemed to be attributable to a particular taxable year to the extent that it represents payments in respect of the alleged violation described in section 1303 (b) (3) which occurred in such year or which continued during any part of such year.

(4) In those cases where a computation has been made by, or under the direction of, a Federal or State agency (including any Federal or State court) by whom the back pay was awarded, which computation indicates that particular portions of such back pay are attributable to certain definite periods of time, such computation shall be accepted as the appropriate allocation for the purposes of this paragraph.

(5) Where no computation has been made as provided in subparagraph (4) of this paragraph, and where the allocation cannot be accurately made in accordance with subparagraph (1), (2), or (3) of this paragraph, then the back pay shall be allocated to each of the taxable years within which falls one or more calendar months included within the entire period for which such back pay has been paid, as if such back pay had been received or accrued in equal portions in each of such calendar months.

(6) An individual must compute his taxable income for any taxable year to which back pay is attributable even though he was not required to make a return for such year. Thus, all amounts properly includible in gross income for any taxable year to which back pay is attributable must be included in the computation.

(d) *Computation of tax.* (1) The following computation shall be made in order to determine whether the limitation on tax prescribed in section 1303 (a) and paragraph (a) of this section applies to back pay received or accrued in the taxable year:

(i) Compute the tax for the current taxable year by including in the gross income of such year the back pay received or accrued in such year.

(ii) Compute the tax for the current taxable year without such inclusion.

(iii) Compute the tax attributable to the back pay allocated to each of the prior taxable years in accordance with paragraph (c) of this section. The amount of tax attributable to back pay in each of such prior taxable years is the difference between the tax for each year computed with the inclusion in gross income of each year of the portion of such back pay so allocated to each year and the tax for each year computed without such inclusion.

(iv) The tax for the current taxable year shall be the lesser of (*a*) the tax for the current taxable year as computed under subdivision (i) of this subparagraph, or (*b*) the tax for such year as computed under subdivision (ii) of this subparagraph, plus the aggregate of the taxes attributable to the allocated back pay as computed under subdivision (iii) of this subparagraph.

(2) For effect of allocation of income on items based on amount of income and with respect to a net operating loss or a capital loss carryover, see paragraph (d) (2) of § 1.1301–2.

(3) See paragraph (d) (4) of § 1.1301–2 for the computations which are necessary when an amount of back pay is allocated to a period to which there has also been allocated other income entitled to the benefits of part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

(4) The provisions of this paragraph may be illustrated by the following example:

Example. A, an unmarried individual with no dependents, makes his returns on the cash receipts and disbursements method of accounting and on the basis of a calendar year. It is assumed that he is entitled to use and uses for the taxable years 1950, 1951, and 1954, the optional tax table provided in section 3 of the Internal Revenue Code of 1954, and Supplement T of the Internal Revenue Code of 1939. In 1954, A received adjusted gross income in the amount of $4,200, of which $1,000 constituted back pay. His tax for the calendar year 1954 on $4,200 would be $665. On $3,200 ($4,200 minus $1,000), the tax would be $467. That part of the tax for 1954 attributable to back pay is, therefore, $198 ($665 minus $467). Of the back pay, $600 was attributable to the year 1951. For such year his adjusted gross income (without such back pay) was $1,700 and his tax thereon was $192. The amount of tax which he would have paid for 1951 had he included in gross income the $600 of back pay attributable to 1951 is $302. The increase in the tax for such year would have been $110 ($302 minus $192). The remainder of the back pay, $400, was attributable to the year 1950, when his adjusted gross income (without such back pay) was $1,200, and his tax was $85. The amount of tax which he would have paid for 1950 had he included in gross income the $400 of back pay attributable to 1950 is $148. The increase in the tax for 1950 would be $63 ($148 minus $85). The aggregate of the increases of taxes for 1951 and 1950 would be $173. A's tax for the calendar year 1954 is $640 ($467 plus $173).

§ 1.1304 Statutory provisions; compensatory damages for patent infringement.

SEC. 1304. *Compensatory damages for patent infringement.* If an amount representing compensatory damages is received or accrued by a taxpayer during a taxable year as the result of an award in a civil action for infringement of a patent issued by the United States, then the tax attributable to the inclusion of such amount in gross income for the taxable year shall not be greater than the aggregate of the increases in taxes which would have resulted if such amount had been included in gross income in equal installments for each month during which such infringement occurred.

[Section 1304 as added by sec. 1, Act of Aug. 11, 1955 (Pub. Law 366, 84th Cong., 69 Stat. 688)]

§ 1.1304–1 Compensatory damages for patent infringement.

(a) *Qualifications for limitation on tax.* If an amount representing compensatory damages is received or accrued by a taxpayer during a taxable year as a result of an award in a civil action for infringement of a patent issued by the United States, then the tax attributable to the inclusion of such amount in gross income for the taxable year shall not be greater than the aggregate of the increases in taxes which would have resulted if such amount had been included in gross income in equal installments for each month over the period during which such infringement occurred.

(b) *Definition of terms*—(1) *"Compensatory damages."* (i) For purposes of section 1304 and this section the term "compensatory damages" means an amount awarded pursuant to a judgment or decree by a court as the result of a civil action for infringement of a patent (or contributory infringement) which action is authorized by title 35 U. S. C. 281. The term is limited to that portion of the award which represents damages to compensate the taxpayer for the actual infringement sustained. It does not include that portion of the award which represents increased damages awarded by the court over and above the amount found adequate to compensate for the infringement, attorney's fees, interest or costs. See 35 U.S.C. 284 and 285.

(ii) An amount awarded pursuant to a consent decree or judgment may be considered compensatory damages for purposes of this section.

(iii) An amount received or accrued pursuant to a settlement of the action, after a decree or judgment awarding damages to the taxpayer has been entered, may be considered as compensatory damages even though such amount is not made a part of a consent decree. In such case the taxpayer must show which portion of the amount received

or accrued represents compensatory damages.

(iv) An amount received or accrued pursuant to a settlement of the action where no judgment or decree, or consent judgment or decree, is entered will not constitute compensatory damages.

(2) *"Patent issued by the United States."* The term "patent issued by the United States" means any patent issued or granted by the United States under the authority of the Commissioner of Patents pursuant to 35 U.S.C. 153. The term "patent issued by the United States" does not include a patent issued or granted by a foreign government.

(c) *Allocation of compensatory damages.* The amount representing compensatory damages is to be treated as if it had been received in equal portions in each of the calendar months (including those of the current taxable year) which fall within the period during which the court has determined the infringement to have occurred. Thus, the portion of the compensatory damages allocable to each taxable year involved in such period is an amount equal to the entire amount of compensatory damages, divided by the entire number of calendar months included within such period of infringement, and multiplied by the number of such calendar months falling within the particular taxable year.

(d) *Computation of tax.* (1) The following computation shall be made in order to determine whether the limitation on tax prescribed in section 1304 and paragraph (a) of this section applies to compensatory damages for a patent infringement received or accrued in the taxable year:

(i) Compute the tax for the current taxable year by including in the gross income of such year the amount of compensatory damages received or accrued in such year.

(ii) Compute the tax for the current taxable year without such inclusion.

(iii) Compute the tax attributable to the portion of the compensatory damages allocated to each of the taxable years in accordance with paragraph (c) of this section. The amount of tax attributable to compensatory damages in each of such years is the difference between the tax for each year computed with the inclusion in gross income of each year of the portion of such compensatory damages so allocated to each year and the tax for each year computed without such inclusion.

(iv) The tax for the current taxable year shall be the lesser of (*a*) the tax for the current taxable year as computed under subdivision (i) of this paragraph, or (*b*) the tax for such year as computed under subdivision (ii) of this subparagraph, plus the aggregate of the taxes attributable to the allocated compensatory damages as computed under subdivision (iii) of this subparagraph.

(2) For effect of allocation of income on items based on amount of income and with respect to a net operating loss or a capital loss carryover, see paragraph (d) (2) of § 1.1301–2.

(3) See paragraph (d) (4) of § 1.1301–2 for the computations which are necessary when an amount of compensatory damages is allocated to a period to which there has also been allocated other income entitled to the benefits of part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

(e) *Capital gains treatment of compensatory damages.* Section 1304 and this section are applicable to amounts considered as received from the sale or exchange of a capital asset. See section 1235 and the regulations thereunder. Whether the portion of the award allocable to each year pursuant to paragraph (c) of this section shall be considered as proceeds from the sale or exchange of a capital asset or as ordinary income shall be determined under the provisions of the internal revenue laws applicable for each such year and the regulations thereunder.

(f) *Effective date of this section.* The provisions of section 1304 and this section shall be applicable with respect to taxable years ending after August 11, 1955, but only with respect to amounts of compensatory damages received or accrued after such date as the result of awards made after such date.

(g) *Illustrations.* The provisions of section 1304 may be illustrated by the following examples:

Example (1). A, the claimant in a patent infringement action, made his return on a calendar year basis and used the cash receipts and disbursements method of accounting. On October 1, 1960, the court awarded him $72,000. Of this amount $10,000 represented legal fees, $6,000 interest, and $4,000 court costs. The balance of $52,000 represented compensatory damages. Moreover, the court found that the infringement began on June 3, 1956, and continued to the date of the award, thus covering a period of 52 calendar months. For the purpose of determining the limitation on tax under section 1304, A must allocate the amount of $52,000 of compensatory damages at the rate of $1,000 per month over the 52 calendar months as follows: $7,000 to 1956, $12,000 to 1957, $12,000 to 1958, $12,000 to 1959, and $9,000 to 1960.

Example (2). Assume the same facts as in example (1) except that on January 2, 1956, A sold his patent to the X Company within the meaning of section 1235. The sale agreement provided that, in the case of any patent infringement, A would bring any necessary actions and would share in any damages collected by such actions. For the purpose of determining the limitation on tax under section 1304, A must treat the amounts allocated to the several years as long-term capital gains.

§ 1.1305 Statutory provisions; breach of contract damages.

SEC. 1305. *Breach of contract damages*—(a) *General rule.* If an amount representing damages is received or accrued by a taxpayer during a taxable year as a result of an award in a civil action for breach of contract or breach of a fiduciary duty or relationship, then the tax attributable to the inclusion in gross income for the taxable year of that part of such amount which would have been received or accrued by the taxpayer in a prior taxable year or years but for the breach of contract, or breach of a fiduciary duty or relationship, shall not be greater than the aggregate of the increases in taxes which would have resulted had such part been included in gross income for such prior taxable year or years.

(b) *Credits and deductions allowed in computation of tax.* The taxpayer in computing said tax shall be entitled to deduct all credits and deductions for depletion, depreciation, and other items to which he would have been entitled, had such income been received or accrued by the taxpayer in the year during which he would have received or accrued it, except for such breach of contract or for such breach of a fiduciary duty or relationship. The credits, deductions, or other items referred to in the prior sentence, attributable to property, shall be allowed only with respect to that part of the award which represents the taxpayer's share of income from the actual operation of such property.

(c) *Limitation.* Subsection (a) shall not apply unless the amount representing damages is $3,000 or more.

[Section 1305 as added by sec. 1, Act of Aug. 26, 1957 (Pub. Law 85–165, 71 Stat. 413)]

§ 1.1305–1 [Reserved]

§ 1.1306 Statutory provisions; rules applicable to part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

SEC. 1306. *Rules applicable to this part*—(a) *Fractional parts of a month.* For purposes of this part, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it should be considered as a month.

(b) *Tax on self-employment income.* This part shall be applied without regard to, and shall not affect, the tax imposed by chapter 2 relating to self-employment income.

(c) *Computation of tax attributable to income allocated to prior period.* For the purpose of computing the tax attributable to the amount of an item of gross income allocable under this part to a particular taxable year, such amount shall be considered income only of the person who would be required to include the item of gross income in a separate return filed for the taxable year in which such item was received or accrued.

(d) *Effective date of certain subsections.* Subsection (c) of section 1301 and subsection (c) of this section shall apply only to amounts received or accrued after March 1, 1954. Notwithstanding any other provision of this title, section 107 of the Internal Revenue Code of 1939 shall apply to amounts received or accrued as a partner on or before March 1, 1954, under this section and to the computation of tax on amounts received or accrued on or before March 1, 1954.

[Section 1306 as renumbered by sec. 1, Act of Aug. 11, 1955 (Pub. Law 366, 84th Cong., 69 Stat. 688); sec. 1, Act of Aug. 26, 1957 (Pub. Law 85–165, 71 Stat. 413)]

§ 1.1306–1 Rules applicable to part I (section 1301 and following), subchapter Q, chapter 1 of the Code.

(a) *Fractional parts of a month.* For purposes of sections 1301, 1302, 1303, 1304, and 1305, and the regulations thereunder, a fractional part of a month shall be disregarded unless it amounts to more than one half of a month, in which case it shall be considered as a month.

(b) *Tax on self-employment income.* The provisions of sections 1301, 1302, 1303, 1304, and 1305, and the regulations thereunder, shall be applied without regard to, and shall not affect, the tax imposed by chapter 2 of the Internal Revenue Code of 1954 and section 480 of the Internal Revenue Code of 1939, relating to the tax on self-employment income.

(c) *Computation of tax attributable to income allocated to prior period.* In the case of either a husband or wife re-

ceiving income to which the provisions of section 1301, 1302, 1303, 1304, or 1305 apply, the tax attributable to the portion of the income allocated to a prior period shall be computed by considering such income as includible by the spouse who would have been required to include it in a separate return for the taxable year in which such income was received or accrued, assuming a separate return had been filed for such year. For example, A, an attorney on a calendar year basis, resides in a State in which the common law with respect to the ownership of property is applicable. In 1955, A receives compensation upon the completion of an employment which began in 1945. All the requirements for the application of section 1301 (a) are satisfied. A and his wife file a joint income tax return for the taxable year 1955. They filed separate returns for the years 1945, 1946, and 1947 and joint returns in 1948 and subsequent years. The entire portion of such compensation allocable to the years for which separate returns were filed shall be includible in A's return and no part thereof shall be includible in the separate return filed by A's wife for such years.

(d) *Effective date.* Section 1304 (c) and this paragraph shall apply only to amounts received or accrued after March 1, 1954. Pursuant to section 7851 (a) (1) (C), the regulations prescribed in this paragraph shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and to taxable years beginning after December 31, 1953, and ending before August 17, 1954, although such years are generally subject to the Internal Revenue Code of 1939. Notwithstanding any other provision of the Internal Revenue Code of 1954, section 107 of the Internal Revenue Code of 1939 shall apply to amounts received or accrued on or before March 1, 1954, and to the computation of tax on amounts received or accrued on or before March 1, 1954.

MITIGATION OF EFFECT OF LIMITATIONS AND OTHER PROVISIONS

§ 1.1311(a) Statutory provisions; correction of error; general rule.

SEC. 1311. *Correction of error*—(a) *General rule.* If a determination (as defined in section 1313) is described in one or more of the paragraphs of section 1312 and, on the date of the determination, correction of the effect of the error referred to in the applicable paragraph of section 1312 is prevented by the operation of any law or rule of law, other than this part and other than section 7122 (relating to compromises), then the effect of the error shall be corrected by an adjustment made in the amount and in the manner specified in section 1314.

§ 1.1311(a)–1 Introduction.

(a) Part II (section 1311 and following), subchapter Q, chapter 1 of the Code, provides certain rules for the correction of the effect of an erroneous treatment of an item in a taxable year which is closed by the statute of limitations or otherwise, in cases where, in connection with the ascertainment of the tax for another taxable year, it has been determined that there was an erroneous treatment of such item in the closed year.

(b) In most situations falling within this part the correction of the effect of the error on a closed year can be made only if either the Commissioner or the taxpayer has taken a position in another taxable year which is inconsistent with the erroneous treatment of the item in the closed year. If a refund or credit would result from the correction of the error in the closed year, then the Commissioner must be the one maintaining the inconsistent position. For example, if the taxpayer erroneously included an item of income on his return for an earlier year which is now closed and the Commissioner successfully requires it to be included in a later year, then the correction of the effect of the erroneous inclusion of that item in the closed year may be made since the Commissioner has maintained a position inconsistent with the treatment of such item in such closed year. On the other hand, if an additional assessment would result from the correction of the error in the closed year, then the taxpayer must be the one maintaining the inconsistent position. For example, if the taxpayer deducted an item in an earlier year which is now closed and he successfully contends that the item should be deducted in a later year, then the correction of the effect of the erroneous deduction of that item in the closed year may be made since the taxpayer has taken a position inconsistent with the treatment of such item in such earlier year.

(c) There are two special circumstances which fall within this part but which do not require that an inconsistent position be maintained. One of these circumstances relates to the inclusion of an item of income in the correct year and the other relates to the allowance of a deduction in the correct year. In the first situation, if the Commissioner takes the position by a deficiency notice or before the Tax Court that an item of income should be included in the gross income of a taxpayer for a particular year and it is ultimately determined that such item was not so includible, then such item can be included in the income of the proper year if that year was not closed at the time the Commissioner took his position. In the second situation, if the taxpayer claims that a deduction should be allowed for a particular year and it is ultimately determined that the deduction was not allowable in that year, then the taxpayer may take the deduction in the proper year if that year was not closed at the time the taxpayer first claimed a deduction.

§ 1.1311(a)–2 Purpose and scope of section 1311.

(a) Section 1311 provides for the correction of the effect of certain errors under circumstances specified in section 1312 when one or more provisions of law, such as the statute of limitations, would otherwise prevent such correction. Section 1311 may be applied to correct the effect of certain errors if, on the date of a determination (as defined in section 1313 (a) and the regulations thereunder), correction is prevented by the operation of any provision of law other than sections 1311 through 1315 and section 7122 (relating to compromises) and the corresponding provisions of prior revenue laws. Examples of provisions preventing such corrections are sections 6501, 6511, 6532, and 6901 (c), (d) and (e), relating to periods of limitations; section 6212 (c) and 6512 relating to the effect of petition to the Tax Court of the United States on further deficiency letters and on credits or refunds; section 7121 relating to closing agreements; and sections 6401 and 6514 relating to payments, refunds, or credits after the period of limitations has expired. Section 1311 may also be applied to correct the effect of an error if, on the date of the determination, correction of the error is prevented by the operation of any rule of law, such as *res judicata* or *estoppel.*

(b) The determination (including a determination under section 1313 (a) (4)) may be with respect to any of the taxes imposed by subtitle A of the Internal Revenue Code of 1954, by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code of 1939, or by the corresponding provisions of any prior revenue act, or by more than one of such provisions. Section 1311 may be applied to correct the effect of the error only as to the tax or taxes with respect to which the error was made which correspond to the tax or taxes with respect to which the determination relates. Thus, if the determination relates to a tax imposed by chapter 1 of the Internal Revenue Code of 1954, the adjustment may be only with respect to the tax imposed by such chapter or by the corresponding provisions of prior law.

(c) Section 1311 is not applicable if, on the date of the determination, correction of the effect of the error is permissible without recourse to said section.

(d) If the tax liability for the year with respect to which the error was made has been compromised under section 7122 or the corresponding provisions of prior revenue laws, no adjustment may be made under section 1311 with respect to said year.

(e) No adjustment may be made under section 1311 for any taxable year beginning prior to January 1, 1932. See section 1314 (d).

(f) Section 1311 applies only to a determination (as defined in section 1313 (a) and §§ 1.1313 (a)–1 to 1.1313 (a)–4, inclusive) made after November 14, 1954. Section 3801 of the Internal Revenue Code of 1939 and the regulations thereunder apply to determinations, as defined therein, made on or before November 14, 1954. See section 1315.

§ 1.1311(b) Statutory provisions; correction of error; conditions necessary for adjustment.

SEC. 1311. *Correction of error.* • • •

(b) *Conditions necessary for adjustment*—(1) *Maintenance of an inconsistent position.* Except in cases described in paragraphs (3) (B) and (4) of section 1312, an adjustment shall be made under this part only if—

(A) In case the amount of the adjustment would be credited or refunded in the same manner as an overpayment under section 1314, there is adopted in the determination a position maintained by the Secretary or his delegate, or

(B) In case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under section 1314,

there is adopted in the determination a position maintained by the taxpayer with respect to whom the determination is made, and the position maintained by the Secretary or his delegate in the case described in subparagraph (A) or maintained by the taxpayer in the case described in subparagraph (B) is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be.

(2) *Correction not barred at time of erroneous action*—(A) *Determination described in section 1312 (3) (B).* In the case of a determination described in section 1312 (3) (B) (relating to certain exclusions from income), adjustment shall be made under this part only if assessment of a deficiency for the taxable year in which the item is includible or against the related taxpayer was not barred, by any law or rule of law, at the time the Secretary or his delegate first maintained, in a notice of deficiency sent pursuant to section 6212 or before the Tax Court of the United States, that the item described in section 1312 (3) (B) should be included in the gross income of the taxpayer for the taxable year to which the determination relates.

(B) *Determination described in section 1312 (4).* In the case of a determination described in section 1312 (4) (relating to disallowance of certain deductions and credits), adjustment shall be made under this part only if credit or refund of the overpayment attributable to the deduction or credit described in such section which should have been allowed to the taxpayer or related taxpayer was not barred, by any law or rule of law, at the time the taxpayer first maintained before the Secretary or his delegate or before the Tax Court of the United States, in writing, that he was entitled to such deduction or credit for the taxable year to which the determination relates.

(3) *Existence of relationship.* In case the amount of the adjustment would be assessed and collected in the same manner as a deficiency (except for cases described in section 1312 (3) (B)), the adjustment shall not be made with respect to a related taxpayer unless he stands in such relationship to the taxpayer at the time the latter first maintains the inconsistent position in a return, claim for refund, or petition (or amended petition) to the Tax Court of the United States for the taxable year with respect to which the determination is made, or if such position is not so maintained, then at the time of the determination.

§ 1.1311(b)–1 Maintenance of an inconsistent position.

(a) *In general.* Under the circumstances stated in § 1.1312–1, § 1.1312–2, paragraph (a) of § 1.1312–3, § 1.1312–5, and § 1.1312–6, the maintenance of an inconsistent position is a condition necessary for adjustment. The requirement in such circumstances is that a position maintained with respect to the taxable year of the determination and which is adopted in the determination be inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, with respect to the taxable year of the error. That is, a position successfully maintained with respect to the taxable year of the determination must be inconsistent with the treatment accorded an item which was the subject of an error in the computation of the tax for the closed taxable year. Adjustments under the circumstances stated in paragraph (b) of § 1.1312–3 and in § 1.1312–4 are made without regard to the maintenance of an inconsistent position.

(b) *Adjustments resulting in refund or credit.* (1) An adjustment under any of the circumstances stated in §§ 1.1312–1, 1.1312–5, or 1.1312–6 which would result in the allowance of a refund or credit is authorized only if (i) the Commissioner, in connection with a determination, has maintained a position which is inconsistent with the erroneous inclusion, omission, disallowance, recognition, or nonrecognition, as the case may be, in the year of the error, and (ii) such inconsistent position is adopted in the determination.

Example. A taxpayer who keeps his books on the cash method erroneously included as income on his return for 1954 an item of accrued interest. After the period of limitations on refunds for 1954 had expired, the district director, on behalf of the Commissioner, proposed an adjustment for the year 1955 on the ground that the item of interest was received in 1955 and, therefore, was properly includible in gross income for that year. The taxpayer and the district director entered into an agreement which meets all of the requirements of § 1.1313 (a)–4 and which determines that the interest item was includible in gross income for 1955. The Commissioner has maintained a position inconsistent with the inclusion of the interest item for 1954. As the determination (the agreement pursuant to § 1.1313(a)–4) adopted such inconsistent position, an adjustment is authorized for the year 1954.

(2) An adjustment under circumstances stated in §§ 1.1312–1, 1.1312–5, or 1.1312–6 which would result in the allowance of a refund or credit is not authorized if the taxpayer with respect to whom the determination is made, and not the Commissioner, has maintained such inconsistent position.

Example. In the example in subparagraph (1) of this paragraph, assume that the Commissioner asserted a deficiency for 1955 based upon other items for that year but, in computing the net income upon which such deficiency was based, did not include the item of interest. The taxpayer appealed to the Tax Court and in his petition asserted that the interest item should be included in gross income for 1955. The Tax Court in 1960 included the item of interest in its redetermination of tax for the year 1955. In such case no adjustment would be authorized for 1954 as the taxpayer, and not the Commissioner, maintained a position inconsistent with the erroneous inclusion of the item of interest in the gross income of the taxpayer for that year.

(c) *Adjustments resulting in additional assessments.* (1) An adjustment under any of the circumstances stated in § 1.1312–2, paragraph (a) of § 1.1312–3, § 1.1312–5, or § 1.1312–6, which would result in an additional assessment is authorized only if (i) the taxpayer with respect to whom the determination is made has, in connection therewith, maintained a position which is inconsistent with the erroneous exclusion, omission, allowance, recognition, or nonrecognition, as the case may be, in the year of the error, and (ii) such inconsistent position is adopted in the determination.

Example. A taxpayer in his return for 1950 claimed and was allowed a deduction for a loss arising from a casualty. After the taxpayer had filed his return for 1951 and after the period of limitations upon the assessment of a deficiency for 1950 had expired, it was discovered that the loss actually occurred in 1951. The taxpayer, therefore, filed a claim for refund for the year 1951 based upon the allowance of a deduction for the loss in that year, and the claim was allowed by the Commissioner in 1955. The taxpayer thus has maintained a position inconsistent with the allowance of the deduction for 1950 by filing a claim for refund for 1951 based upon the same deduction. As the determination (the allowance of the claim for refund) adopts such inconsistent position, an adjustment is authorized for the year 1950.

(2) An adjustment under the circumstances stated in § 1.1312–2, paragraph (a) of § 1.1312–3, § 1.1312–5, or § 1.1312–6 which would result in an additional assessment is not authorized if the Commissioner, and not the taxpayer, has maintained such inconsistent position.

Example. In the example in subparagraph (1) of this paragraph, assume that the taxpayer did not file a claim for refund for 1951 but the Commissioner issued a notice of deficiency for 1951 based upon other items. The taxpayer filed a petition with the Tax Court of the United States and the Commissioner in his answer voluntarily proposed the allowance for 1951 of a deduction for the loss previously allowed for 1950. The Tax Court took the deduction into account in its redetermination in 1955 of the tax for the year 1951. In such case no adjustment would be authorized for the year 1950 as the Commissioner, and not the taxpayer, has maintained a position inconsistent with the allowance of a deduction for the loss in that year.

§ 1.1311(b)–2 Correction not barred at time of erroneous action.

(a) An adjustment under the circumstances stated in paragraph (b) of §1.-1312–3 (relating to the double exclusion of an item of gross income) which would result in an additional assessment, is authorized only if assessment of a deficiency against the taxpayer or related taxpayer for the taxable year in which the item is includible was not barred by any law or rule of law at the time the Commissioner first maintained, in a notice of deficiency sent pursuant to section 6212 (or section 272 (a) of the Internal Revenue Code of 1939) or before the Tax Court of the United States, that the item described in paragraph (b) of § 1.1312–3 should be included in the gross income of the taxpayer in the taxable year to which the determination relates.

(b) An adjustment under the circumstances stated in § 1.1312–4 (relating to the double disallowance of a deduction or credit), which would result in the allowance of a credit or refund, is authorized only if a credit or refund to the taxpayer or related taxpayer, attributable to such adjustment, was not barred by any law or rule of law when the taxpayer first maintained in writing before the Commissioner or the Tax Court that he was entitled to such deduction or credit for the taxable year to which the determination relates. The taxpayer will be considered to have first maintained in writing before the Commissioner or the Tax Court that he was entitled to such deduction or credit when he first formally asserts his right to such deduction or credit as, for example, in a return, in a claim for refund, or in a

petition (or an amended petition) before the Tax Court.

(c) Under the circumstances of adjustment with respect to which the conditions stated in this section are applicable, the conditions stated in § 1.1311 (b)–1 (maintenance of an inconsistent position) are not required. See paragraph (b) of § 1.1312–3 and § 1.1312–4 for examples of the application of this section.

§ 1.1311(b)–3 Existence of relationship in case of adjustment by way of deficiency assessment.

(a) Except for cases described in paragraph (b) of § 1.1312–3, no adjustment by way of a deficiency assessment shall be made, with respect to a related taxpayer, unless the relationship existed both at some time during the taxable year with respect to which the error was made and at the time the taxpayer with respect to whom the determination is made first maintained the inconsistent position with respect to the taxable year to which the determination relates. In the case of an adjustment by way of a deficiency assessment under the circumstance described in paragraph (b) of § 1.1312–3 (where the maintenance of an inconsistent position is not required), the relationship need exist only at some time during the taxable year in which the error was made.

(b) If the inconsistent position is maintained in a return, claim for refund, or petition (or amended petition) to the Tax Court of the United States for the taxable year in respect to which the determination is made, the requisite relationship must exist on the date of filing such document. If the inconsistent position is maintained in more than one of such documents, the requisite date is the date of filing of the document in which it was first maintained. If the inconsistent position was not thus maintained, then the relationship must exist on the date of the determination as, for example, where at the instance of the taxpayer a deduction is allowed, the right to which was not asserted in a return, claim for refund, or petition to the Tax Court, and a determination is effected by means of a closing agreement or an agreement under section 1313 (a) (4).

§ 1.1312 Statutory provisions; circumstances of adjustment.

SEC. 1312. *Circumstances of adjustment.* The circumstances under which the adjustment provided in section 1311 is authorized are as follows:

(1) *Double inclusion of an item of gross income.* The determination requires the inclusion in gross income of an item which was erroneously included in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer.

(2) *Double allowance of a deduction or credit.* The determination allows a deduction or credit which was erroneously allowed to the taxpayer for another taxable year or to a related taxpayer.

(3) *Double exclusion of an item of gross income*—(A) *Items included in income.* The determination requires the exclusion from gross income of an item included in a return filed by the taxpayer or with respect to which tax was paid and which was erroneously excluded or omitted from the gross income of the taxpayer for another taxable year, or from the gross income of a related taxpayer; or

(B) *Items not included in income.* The determination requires the exclusion from gross income of an item not included in a return filed by the taxpayer and with respect to which the tax was not paid but which is includible in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer.

(4) *Double disallowance of a deduction or credit.* The determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, or to a related taxpayer.

(5) *Correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs.* The determination allows or disallows any of the additional deductions allowable in computing the taxable income of estates or trusts, or requires or denies any of the inclusions in the computation of taxable income of beneficiaries, heirs, or legatees, specified in subparts A to E, inclusive (secs. 641 and following, relating to estates, trusts, and beneficiaries), of part I of subchapter J of this chapter, or corresponding provisions of prior internal revenue laws, and the correlative inclusion or deduction, as the case may be, has been erroneously excluded, omitted, or included, or disallowed, omitted, or allowed, as the case may be, in respect of the related taxpayer.

(6) *Basis of property after erroneous treatment of a prior transaction*—(A) *General rule.* The determination determines the basis of property, and in respect of any transaction on which such basis depends, or in respect of any transaction which was erroneously treated as affecting such basis, there occurred, with respect to a taxpayer described in subparagraph (B) of this paragraph, any of the errors described in subparagraph (C) of this paragraph.

(B) *Taxpayers with respect to whom the erroneous treatment occurred.* The taxpayer with respect to whom the erroneous treatment occurred must be—

(i) The taxpayer with respect to whom the determination is made,

(ii) A taxpayer who acquired title to the property in the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, or

(iii) A taxpayer who had title to the property at the time of the transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015 (a) (relating to the basis of property acquired by gift).

(C) *Prior erroneous treatment.* With respect to a taxpayer described in subparagraph (B) of this paragraph—

(i) There was an erroneous inclusion in, or omission from, gross income,

(ii) There was an erroneous recognition, or non-recognition, of gain or loss, or

(iii) There was an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

§ 1.1312–1 Double inclusion of an item of gross income.

(a) Paragraph (1) of section 1312 applies if the determination requires the inclusion in a taxpayer's gross income of an item which was erroneously included in the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example (1). A taxpayer who keeps his books on the cash method erroneously included in income on his return for 1947 an item of accrued rent. In 1952, after the period of limitation on refunds for 1947 had expired, the Commissioner discovered that the taxpayer received this rent in 1948 and asserted a deficiency for the year 1948 which is sustained by the Tax Court of the United States in 1955. An adjustment in favor of the taxpayer is authorized with respect to the year 1947. If the taxpayer had returned the rent for both 1947 and 1948 and by a determination was denied a refund claim for 1948 on account of the rent item, a similar adjustment is authorized.

Example (2). A husband assigned to his wife salary to be earned by him in the year 1952. The wife included such salary in her separate return for that year and the husband omitted it. The Commissioner asserted a deficiency against the wife for 1952 with respect to a different item; she contested that deficiency, and the Tax Court entered an order in her case which became final in 1955. The wife would therefore be barred by section 6512 (a) from claiming a refund for 1952. Thereafter, the Commissioner asserted a deficiency against the husband on account of the omission of such salary from his return for 1952. In 1955 the husband and the Commissioner enter into a closing agreement for the year 1952 in which the salary is taxed to the husband. An adjustment is authorized with respect to the wife's tax for 1952.

§ 1.1312–2 Double allowance of a deduction or credit.

(a) Paragraph (2) of section 1312 applies if the determination allows the taxpayer a deduction or credit which was erroneously allowed the same taxpayer for another taxable year or a related taxpayer for the same or another taxable year.

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example (1). A taxpayer in his return for 1950 claimed and was allowed a deduction for destruction of timber by a forest fire. Subsequently, it was discovered that the forest fire occurred in 1951 rather than 1950. After the expiration of the period of limitations for the assessment of a deficiency for 1950, the taxpayer filed a claim for refund for 1951 based upon a deduction for the fire loss in that year. The Commissioner in 1955 allows the claim for refund. An adjustment is authorized with respect to the year 1950.

Example (2). The beneficiary of a testamentary trust in his return for 1949 claimed, and was allowed, a deduction for depreciation of the trust property. The Commissioner asserted a deficiency against the beneficiary for 1949 with respect to a different item and a final decision of the Tax Court of the United States was rendered in 1951, so that the Commissioner was thereafter barred by section 272 (f) of the Internal Revenue Code of 1939 from asserting a further deficiency against the beneficiary for 1949. The trustee thereafter filed a timely refund claim contending that, under the terms of the will, the trust, and not the beneficiary, was entitled to the allowance for depreciation. The court in 1955 sustains

the refund claim. An adjustment is authorized with respect to the beneficiary's tax for 1949.

§ 1.1312–3 Double exclusion of an item of gross income.

(a) *Items included in income or with respect to which a tax was paid.* (1) Paragraph (3)(A) of section 1312 applies if the determination requires the exclusion, from a taxpayer's gross income, of an item included in a return filed by the taxpayer, or with respect to which tax was paid, and which was erroneously excluded or omitted from the gross income of the same taxpayer for another taxable year or of a related taxpayer for the same or another taxable year.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (i). (i) A taxpayer received payments in 1951 under a contract for the performance of services and included the payments in his return for that year. After the expiration of the period of limitations for the assessment of a deficiency for 1950, the Commissioner issued a notice of deficiency to the taxpayer for the year 1951 based upon adjustments to other items, and the taxpayer filed a petition with the Tax Court of the United States and maintained in the proceeding before the Tax Court that he kept his books on the accrual basis and that the payments received in 1951 were on income that had accrued and was properly taxable in 1950. A final decision of the Tax Court was rendered in 1955 excluding the payments from 1951 income. An adjustment in favor of the Commissioner is authorized with respect to the year 1950, whether or not a tax had been paid on the income reported in the 1951 return.

(ii) Assume the same facts as in (i), except that the taxpayer had not included the payments in any return and had not paid a tax thereon. No adjustment would be authorized under section 1312 (3) (A) with respect to the year 1950. If the taxpayer, however, had paid a deficiency asserted for 1951 based upon the inclusion of the payments in 1951 income and thereafter successfully sued for refund thereof, an adjustment would be authorized with respect to the year 1950. (See paragraph (b) of this section for circumstances under which correction is authorized with respect to items not included in income and on which a tax was not paid.)

Example (2). A father and son conducted a partnership business, each being entitled to one-half of the net profits. The father included the entire net income of the partnership in his return for 1948, and the son included no portion of this income in his return for that year. Shortly before the expiration of the period of limitations with respect to deficiency assessments and refund claims for both father and son for 1948, the father filed a claim for refund of that portion of his 1948 tax attributable to the half of the partnership income which should have been included in the son's return. The court sustains the claim for refund in 1955. An adjustment is authorized with respect to the son's tax for 1948.

(b) *Items not included in income and with respect to which the tax was not paid.* (1) Paragraph (3)(B) of section 1312 applies if the determination requires the exclusion from gross income of an item not included in a return filed by the taxpayer and with respect to which a tax was not paid, but which is includible in the gross income of the same taxpayer for another taxable year, or in the gross income of a related taxpayer for the same or another taxable year. This is one of the two circumstances in which the maintenance of an inconsistent position is not a requirement for an adjustment, but the requirements in paragraph (a) of § 1.1311 (b)–2 must be fulfilled (correction not barred at time of erroneous action).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). The taxpayer, A, who computes his income by use of the accrual method of accounting, performed in 1949 services for which he received payments in 1949 and 1950. He did not include in his return for either 1949 or 1950 the payments which he received in 1950, and he paid no tax with respect to such payments. In 1952 the Commissioner sent a notice of deficiency to A with respect to the year 1949, contending that A should have included all of such payments in his return for that year. A contested the deficiency on the basis that in 1949 he had no accruable right to the payments which he received in 1950. In 1955 (after the expiration of the period of limitations for assessing deficiencies with respect to 1950), the Tax Court sustains A's position. The Commissioner may assess a deficiency for 1950, since a deficiency assessment for that year was not barred when he sent the notice of deficiency with respect to 1949.

Example (2). B and C were partners in 1950, each being entitled to one-half of the profits of the partnership business. During 1950, B received an item of income which he treated as partnership income so that his return for that year reflected only 50 percent of such item. C, however, included no part of such item in any return and paid no tax with respect thereto. In 1952, the Commissioner sent to C a notice of deficiency with respect to 1950, contending that his return for that year should have reflected 50 percent of such item. C contested the deficiency on the basis that such item was not partnership income. In 1955, after the expiration of the period of limitations for assessing deficiencies with respect to 1950, the Tax Court sustained C's position. The Commissioner may assess a deficiency against B with respect to 1950 requiring him to include the entire amount of such item in his income since assessment of the deficiency was not barred when the Commissioner sent the notice of deficiency with respect to such item to C.

§ 1.1312–4 Double disallowance of a deduction or credit.

(a) Paragraph (4) of section 1312 applies if the determination disallows a deduction or credit which should have been, but was not, allowed to the same taxpayer for another taxable year or to a related taxpayer for the same or another taxable year. This is one of the two circumstances in which the maintenance of an inconsistent position is not a requirement for an adjustment but the requirements in paragraph (b) of § 1.1311(b)–2 must be fulfilled (correction not barred at time of erroneous action).

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example (1). The taxpayer, A, who computes his income by use of the accrual method of accounting, deducted in his return for the taxable year 1951 an item of expense which he paid in such year. At the time A filed his return for 1951, the statute of limitations for 1950 had not expired. Subsequently, the Commissioner asserted a deficiency for 1951 based on the position that the liability for such expense should have been accrued for the taxable year 1950. In 1955, after the period of limitations on refunds for 1950 had expired, there was a determination by the Tax Court disallowing such deduction for the taxable year 1951. A is entitled to an adjustment for the taxable year 1950. However, if such liability should have been accrued for the taxable year 1946 instead of 1950, A would not be entitled to an adjustment, if a credit or refund with respect to 1946 was already barred when he deducted such expense for the taxable year 1951.

Example (2). The taxpayer, B, in his return for 1951 claimed a deduction for a charitable contribution. The Commissioner asserted a deficiency for such year contending that 50 percent of the deduction should be disallowed, since the contribution was made from community property 50 percent of which was attributable to B's spouse. The deficiency is sustained by the Tax Court in 1956, subsequent to the period of limitations within which B's spouse could claim a refund with respect to 1951. An adjustment is permitted to B's spouse, a related taxpayer, since a refund attributable to a deduction by her of such contribution was not barred when B claimed the deduction.

§ 1.1312–5 Correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs.

(a) Paragraph (5) of section 1312 applies to distributions by a trust or an estate to the beneficiaries, heirs, or legatees. If the determination relates to the amount of the deduction allowed by sections 651 and 661 or the inclusion in taxable income of the beneficiary required by sections 652 and 662 (including amounts falling within subpart D, subchapter J, chapter 1 of the Code, relating to treatment of excess distributions by trusts), or if the determination relates to the additional deduction (or inclusion) specified in section 162 (b) and (c) of the Internal Revenue Code of 1939 (or the corresponding provisions of a prior revenue act), with respect to amounts paid, credited, or required to be distributed to the beneficiaries, heirs, and legatees, and such determination requires:

(1) The allowance to the estate or trust of the deduction when such amounts have been erroneously omitted or excluded from the income of the beneficiaries, heirs, or legatees; or

(2) The inclusion of such amounts in the income of the beneficiaries, heirs, or legatees when the deduction has been erroneously disallowed to or omitted by the estate or trust; or

(3) The disallowance to an estate or trust of the deduction when such amounts have been erroneously included in the income of the beneficiaries, heirs, or legatees; or

(4) The exclusion of such amounts from the income of the beneficiaries, heirs, or legatees when the deduction has been erroneously allowed to the estate or trust.

(b) The application of paragraph (a) (1) of this section may be illustrated by the following example:

Example. For the taxable year 1954, a trustee, directed by the trust instrument to accumulate the trust income, made no distribution to the beneficiary and returned the entire income as taxable to the trust. Accordingly the beneficiary did not include the trust income in his return for the year

1954. In 1957, a State court holds invalid the clause directing accumulation and determines that the income is required to be currently distributed. It also rules that certain extraordinary dividends which the trustee in good faith allocated to corpus in 1954 were properly allocable to income. In 1958, the trustee, relying upon the court decision, files a claim for refund of the tax paid on behalf of the trust for the year 1954 and thereafter files a suit in the District Court. The claim is sustained by the court (except as to the tax on the extraordinary dividends) in 1959 after the expiration of the period of limitations upon deficiency assessments against the beneficiary for the year 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954. The treatment of the distribution to the beneficiary of the extraordinary dividends shall be determined under subpart D of subchapter J.

(c) The application of paragraph (a) (2) of this section may be illustrated by the following example:

Example. Assume the same facts as in the example in paragraph (b) of this section, except that, instead of the trustee's filing a refund claim, the Commissioner, relying upon the decision of the State court, asserts a deficiency against the beneficiary for 1954. The deficiency is sustained by final decision of the Tax Court of the United States in 1959, after the expiration of the period for filing claim for refund on behalf of the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

(d) The application of paragraph (a) (3) of this section may be illustrated by the following example:

Example. A trustee claimed in the trust return for 1954 for amounts paid to the beneficiary a deduction to the extent of distributable net income. This amount was included by the beneficiary in gross income in his return for 1954. In computing distributable net income the trustee had included short and long-term capital gains. In 1958, the Commissioner asserts a deficiency against the trust on the ground that the capital gains were not includible in distributable net income, and that, therefore, the gains were taxable to the trust, not the beneficiary. The deficiency is sustained by a final decision of the Tax Court in 1960, after the expiration of the period for filing claims for refund by the beneficiary for 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954, based on the exclusion from 1954 gross income of the capital gains previously considered distributed by the trust under section 662.

(e) The application of paragraph (a) (4) of this section may be illustrated by the following example:

Example. Assume the same facts as in the example in paragraph (d) of this section, except that, instead of the Commissioner's asserting a deficiency, the beneficiary filed a refund claim for 1954 on the same ground. The claim is sustained by the court in 1960 after the expiration of the period of limitations upon deficiency assessments against the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

§ 1.1312–6 Basis of property after erroneous treatment of a prior transaction.

(a) Paragraph (6) of section 1312 applies if the determination establishes the basis of property, and there occurred one of the following types of errors in respect of a prior transaction upon which such basis depends, or in respect of a prior transaction which was erroneously treated as affecting such basis:

(1) An erroneous inclusion in, or omission from, gross income, or

(2) An erroneous recognition or nonrecognition of gain or loss, or

(3) An erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

(b) For this section to apply, the taxpayer with respect to whom the erroneous treatment occurred must be—

(1) The taxpayer with respect to whom the determination is made, or

(2) A taxpayer who acquired title to the property in the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title in such a manner that he will have a basis ascertained by reference to the basis in the hands of the taxpayer who acquired title to the property in the erroneously treated transaction, or

(3) A taxpayer who had title to the property at the time of the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015 (a) (relating to the basis of property acquired by gift). No adjustment is authorized with respect to the transferor of the property in a transaction upon which the basis of the property depends, when the determination is with respect to the original transferee or a subsequent transferee of such original transferee.

(c) The application of this section may be illustrated by the following examples:

Example (1). In 1949 taxpayer A transferred property which had cost him $5,000 to the X Corporation in exchange for an original issue of shares of its stock having a fair market value of $10,000. In his return for 1949 taxpayer A treated the exchange as one in which the gain or loss was not recognizable:

(i) In 1955 the X Corporation maintains that the gain should have been recognized in the exchange in 1949 and therefore the property it received had a $10,000 basis for depreciation. Its position is adopted in a closing agreement. No adjustment is authorized with respect to the tax of the X Corporation for 1949, as none of the three types of errors specified in paragraph (a) of this section occurred with respect to the X Corporation in the treatment of the exchange in 1949. Moreover, no adjustment is authorized with respect to taxpayer A, as he is not within any of the three classes of taxpayers described in paragraph (b) of this section.

(ii) In 1953 taxpayer A sells the stock which he received in 1949 and maintains that, as gain should have been recognized in the exchange in 1949, the basis for computing the profit on the sale is $10,000. His position is confirmed in a closing agreement executed in 1955. An adjustment is authorized with respect to his tax for the year 1949 as the basis for computing the gain on the sale depends upon the transaction in 1949, and in respect of that transaction there was an erroneous nonrecognition of gain to taxpayer A, the taxpayer with respect to whom the determination is made.

Example (2). In 1950 taxpayer A was the owner of 10 shares of the common stock of the Z Corporation which had a basis of $1,500. In that year he received as a dividend thereon 10 shares of the preferred stock of the same corporation having a fair market value of $1,000. On his books, entries were made reducing the basis of the common stock by allocating $500 of the basis to the preferred stock, and on his return for 1950 he did not include the dividend in gross income.

(i) In 1951 taxpayer A made a gift of the preferred stock of the Z Corporation to taxpayer B, an unrelated individual. Taxpayer B sold the stock in 1953 and on his return for that year he reported the sale and claimed a basis of $1,000, contending that the dividend of preferred stock was taxable to A in 1950 at its fair market value of $1,000. The basis of $1,000 is confirmed by a closing agreement executed in 1955. An adjustment is authorized with respect to taxpayer A's tax for 1950, as the closing agreement determines basis of property, and in a prior transaction upon which such basis depends there was an erroneous omission from gross income of taxpayer A, a taxpayer who acquired title to the property in the erroneously treated transaction and from whom, immediately, the taxpayer with respect to whom the determination is made derived title.

(ii) Assuming the same facts as in (i) except that the common stock instead of the preferred stock was the subject of the gift, and the basis claimed by taxpayer B and confirmed in the closing agreement was $1,500. An adjustment is authorized with respect to taxpayer A's tax for 1950, as the closing agreement determines the basis of property, and in a prior transaction which was erroneously treated as affecting such basis there was an erroneous omission from gross income of taxpayer A, a taxpayer who had title to the property at the time of the erroneously treated transaction, and from whom, immediately, taxpayer B, with respect to whom the determination is made, derived title. The basis of the property in taxpayer B's hands with respect to whom the determination is made is determined under section 1015 (a) (relating to the basis of property acquired by gift).

Example (3). In 1950 taxpayer A sold property acquired at a cost of $5,000 to taxpayer B for $10,000. In his return for 1950 taxpayer A failed to include the profit on such sale. In 1953 taxpayer B sold the property for $12,000, and in his return for 1953 reported a gain of $2,000 upon the sale, which is confirmed by a closing agreement executed in 1955. No adjustment is authorized with respect to the tax of taxpayer A for 1950, as he does not come within any of the three classes of taxpayers described in paragraph (b) of this section.

Example (4). In 1950 a taxpayer who owned 100 shares of stock in Corporation Y received $1,000 from the corporation which amount the taxpayer reported on his return for 1950 as a taxable dividend. In 1952 Corporation Y was completely liquidated and the taxpayer received in that year liquidating distributions totalling $8,000. In his return for 1952 the taxpayer reported the receipt of the $8,000 and computed his gain or loss upon the liquidation by using as a basis the amount which he paid for the stock. The Commissioner maintained that the distribution in 1950 was a distribution out of capital and that in computing the taxpayer's gain or loss upon the liquidation in 1952, the basis of the stock should be reduced by the $1,000. This position is adopted in a closing agreement executed in 1955 with respect to the year 1952. An adjustment is authorized with respect to the

year 1950 as the basis for computing gain or loss in 1952 depends upon the transaction in 1950, and in respect of the 1950 transaction (upon which the basis of the property depends) there was an erroneous inclusion in gross income of the taxpayer with respect to whom the determination is made.

Example (5). In 1946 a taxpayer received 100 shares of stock of the X Corporation having a fair market value of $5,000, in exchange for shares of stock in the Y Corporation which he had acquired at a cost of $12,000. In his return for 1946 the taxpayer treated the exchange as one in which gain or loss was not recognizable. The taxpayer sold 50 shares of the X Corporation stock in 1947 and in his return for that year treated such shares as having a $6,000 basis. In 1952, the taxpayer sold the remaining 50 shares of stock of the X Corporation for $7,500 and reported $1,500 gain in his return for 1952. After the expiration of the period of limitations on deficiency assessments and on refund claims for 1946 and 1947, the Commissioner asserted a deficiency for 1952 on the ground that the loss realized on the exchange in 1946 was erroneously treated as nonrecognizable, and the basis for computing gain upon the sale in 1952 was $2,500, resulting in a gain of $5,000. The deficiency is sustained by the Tax Court in 1955. An adjustment is authorized with respect to the year 1946 as to the entire $7,000 loss realized on the exchange, as the Court's decision determines the basis of property, and in a prior transaction upon which such basis depends there was an erroneous nonrecognition of loss to the taxpayer with respect to whom the determination was made. No adjustment is authorized with respect to the year 1947 as the basis for computing gain upon the sale of the 50 shares in 1952 does not depend upon the transaction in 1947 but upon the transaction in 1946.

§ 1.1312–7 Law applicable in determination of error.

The question whether there was an erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition is determined under the provisions of the internal revenue laws applicable with respect to the year as to which the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was made. The fact that the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, was in pursuance of an interpretation, either judicial or administrative, accorded such provisions of the internal revenue laws at the time of such action is not necessarily determinative of this question. For example, if a later judicial decision authoritatively alters such interpretation so that such action was contrary to such provisions of the internal revenue laws as later interpreted, the inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be, is erroneous within the meaning of section 1312.

§ 1.1313(a) Statutory provisions; definition of determination.

SEC. 1313. *Definitions*—(a) *Determination.* For purposes of this part, the term "determination" means—

(1) A decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(2) A closing agreement made under section 7121;

(3) A final disposition by the Secretary or his delegate of a claim for refund. For purposes of this part, a claim for refund shall be deemed finally disposed of by the Secretary or his delegate—

(A) As to items with respect to which the claim was allowed, on the date of allowance of refund or credit or on the date of mailing notice of disallowance (by reason of offsetting items) of the claim for refund, and

(B) As to items with respect to which the claim was disallowed, in whole or in part, or as to items applied by the Secretary or his delegate in reduction of the refund or credit, on expiration of the time for instituting suit with respect thereto (unless suit is instituted before the expiration of such time); or

(4) Under regulations prescribed by the Secretary or his delegate, an agreement for purposes of this part, signed by the Secretary or his delegate and by any person, relating to the liability of such person (or the person for whom he acts) in respect of a tax under this subtitle for any taxable period.

§ 1.1313(a)–1 Decision by Tax Court or other court as a determination.

(a) A determination may take the form of a decision by the Tax Court of the United States or a judgment, decree, or other order by any court of competent jurisdiction, which has become final.

(b) The date upon which a decision by the Tax Court becomes final is prescribed in section 7481.

(c) The date upon which a judgment of any other court becomes final must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

§ 1.1313(a)–2 Closing agreement as a determination.

A determination may take the form of a closing agreement authorized by section 7121. Such an agreement may relate to the total tax liability of the taxpayer for a particular taxable year or years or to one or more separate items affecting such liability. A closing agreement becomes final for the purpose of this section on the date of its approval by the Commissioner.

§ 1.1313(a)–3 Final disposition of claim for refund as a determination.

(a) *In general.* A determination may take the form of a final disposition of a claim for refund. Such disposition may result in a determination with respect to two classes of items, i. e., items included by the taxpayer in a claim for refund and items applied by the Commissioner to offset the alleged overpayment. The time at which a disposition in respect of a particular item becomes final may depend not only upon what action is taken with respect to that item but also upon whether the claim for refund is allowed or disallowed.

(b) *Items with respect to which the taxpayer's claim is allowed.* (1) The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is sustained becomes final on the date of allowance of the refund or credit if—

(i) The taxpayer's claim for refund is unqualifiedly allowed; or

(ii) The taxpayer's contention with respect to an item is sustained and with respect to other items is denied, so that the net result is an allowance of refund or credit; or

(iii) The taxpayer's contention with respect to an item is sustained, but the Commissioner applies other items to offset the amount of the alleged overpayment and the items so applied do not completely offset such amount but merely reduce it so that the net result is an allowance of refund or credit.

(2) If the taxpayer's contention in the claim for refund with respect to an item is sustained but the Commissioner applies other items to offset the amount of the alleged overpayment so that the net result is a disallowance of the claim for refund, the date of mailing, by registered mail, of the notice of disallowance (see section 6532) is the date of the final disposition as to the item with respect to which the taxpayer's contention is sustained.

(c) *Items with respect to which the taxpayer's claim is disallowed.* The disposition with respect to an item as to which the taxpayer's contention in the claim for refund is denied becomes final upon the expiration of the time allowed by section 6532 for instituting suit on the claim for refund, unless the suit is instituted prior to the expiration of such period, if—

(1) The taxpayer's claim for refund is unqualifiedly disallowed; or

(2) The taxpayer's contention with respect to an item is denied and with respect to other items is sustained so that the net result is an allowance of refund or credit; or

(3) The taxpayer's contention with respect to an item is sustained in part and denied in part. For example, assume that the taxpayer claimed a deductible loss of $10,000 and a consequent overpayment of $2,500 and the Commissioner concedes that a deductible loss was sustained, but only in the amount of $5,000. The disposition of the claim for refund with respect to the allowance of the $5,000 and the disallowance of the remaining $5,000 becomes final upon the expiration of the time for instituting suit on the claim for refund unless suit is instituted prior to the expiration of such period.

(d) *Items applied by the Commissioner in reduction of the refund or credit.* If the Commissioner applies an item in reduction of the overpayment alleged in the claim for refund, and the net result is an allowance of refund or credit, the disposition with respect to the item so applied by the Commissioner becomes final upon the expiration of the time allowed by section 6532 for instituting suit on the claim for refund, unless suit is instituted prior to the expiration of such period. If such application of the item results in the assertion of a deficiency, such action does not constitute a final disposition of a claim for refund within the meaning of § 1.1313 (a)–3, but subsequent action taken with

respect to such deficiency may result in a determination under §§ 1.1313 (a)–1, 1.1313 (a)–2, or 1.1313 (a)–4.

(e) *Elimination of waiting period.* The necessity of waiting for the expiration of the 2-year period of limitations provided in section 6532 may be avoided in such cases as are described in paragraph (c) or (d) of this section by the use of a closing agreement (see § 1.1313 (a)–2) or agreement under § 1.1313 (a)–4 to effect a determination.

§ 1.1313(a)–4 Agreement pursuant to section 1313(a)(4) as a determination.

(a) *In general.* (1) A determination may take the form of an agreement made pursuant to this section. This section is intended to provide an expeditious method for obtaining an adjustment under section 1311 and for offsetting deficiencies and refunds whenever possible. The provisions of part II (section 1311 and following), subchapter Q, chapter 1 of the Code, must be strictly complied with in any such agreement.

(2) An agreement made pursuant to this section will not, in itself, establish the tax liability for the open taxable year to which it relates, but it will state the amount of the tax, as then determined, for such open year. The tax may be the amount of tax shown on the return as filed by the taxpayer, but if any changes in the amount have been made, or if any are being made by documents executed concurrently with the execution of said agreement, such changes must be taken into account. For example, an agreement pursuant to this section may be executed concurrently with the execution of a waiver of restrictions on assessment and collection of a deficiency or acceptance of an overassessment with respect to the open taxable year, or concurrently with the execution and filing of a stipulation in a proceeding before the Tax Court of the United States, where an item which is to be the subject of an adjustment under section 1311 is disposed of by the stipulation and is not left for determination by the court.

(b) *Contents of agreement.* An agreement made pursuant to this section shall be so designated in the heading of the agreement, and it shall contain the following:

(1) A statement of the amount of the tax determined for the open taxable year to which the agreement relates, and if said liability is established or altered by a document executed concurrently with the execution of the agreement, a reference to said document.

(2) A concise statement of the material facts with respect to the item that was the subject of the error in the closed taxable year or years, and a statement of the manner in which such item was treated in computing the tax liability set forth pursuant to subparagraph (1) of this paragraph.

(3) A statement as to the amount of the adjustment ascertained pursuant to § 1.1314 (a)–1 for the taxable year with respect to which the error was made and, where applicable, a statement as to the amount of the adjustment or adjustments ascertained pursuant to § 1.1314 (a)–2 with respect to any other taxable year or years; and

(4) A waiver of restrictions on assessment and collection of any deficiencies set forth pursuant to subparagraph 3 of this paragraph.

(c) *Execution and effect of agreement.* An agreement made pursuant to this section shall be signed by the taxpayer with respect to whom the determination is made, or on the taxpayer's behalf by an agent or attorney acting pursuant to a power of attorney on file with the Internal Revenue Service. If an adjustment is to be made in a case of a related taxpayer, the agreement shall be signed also by the related taxpayer, or on the related taxpayer's behalf by an agent or attorney acting pursuant to a power of attorney on file with the Internal Revenue Service. It may be signed on behalf of the Commissioner by the district director, or such other person as is authorized by the Commissioner. When duly executed, such agreement will constitute the authority for an allowance of any refund or credit agreed to therein, and for the immediate assessment of any deficiency agreed to therein for the taxable year with respect to which the error was made, or any closed taxable year or years affected, or treated as affected, by a net operating loss deduction or capital loss carryover determined with reference to the taxable year with respect to which the error was made.

(d) *Finality of determination.* A determination made by an agreement pursuant to this section becomes final when the tax liability for the open taxable year to which the determination relates becomes final. During the period, if any, that a deficiency may be assessed or a refund or credit allowed with respect to such year, either the taxpayer or the Commissioner may properly pursue any of the procedures provided by law to secure a further modification of the tax liability for such year. For example, if the taxpayer subsequently files a claim for refund, or if the Commissioner subsequently issues a notice of deficiency with respect to such year, either may adopt a position with respect to the item that was the subject of the adjustment that is at variance with the manner in which said item was treated in the agreement. Any assessment, refund, or credit that is subsequently made with respect to the tax liability for such open taxable year, to the extent that it is based upon a revision in the treatment of the item that was the subject of the adjustment, shall constitute an alteration or revocation of the determination for the purpose of a redetermination of the adjustment pursuant to paragraph (d) of § 1.1314 (b)–1.

§ 1.1313(b)–(c) Statutory provisions; definitions of taxpayer and related taxpayer.

SEC. 1313. *Definitions.* • • •

(b) *Taxpayer.* Notwithstanding section 7701 (a) (14), the term "taxpayer" means any person subject to a tax under the applicable revenue law.

(c) *Related taxpayer.* For purposes of this part, the term "related taxpayer" means a taxpayer who, with the taxpayer with respect to whom a determination is made, stood, in the taxable year with respect to which the erroneous inclusion, exclusion, omission, allowance, or disallowance was made, in one of the following relationships:

(1) Husband and wife,
(2) Grantor and fiduciary,
(3) Grantor and beneficiary,
(4) Fiduciary and beneficiary, legatee, or heir,
(5) Decedent and decedent's estate,
(6) Partner, or
(7) Member of an affiliated group of corporations (as defined in section 1504).

§ 1.1313(c)–1 Related taxpayer.

An adjustment in the case of the taxpayer with respect to whom the error was made may be authorized under section 1311 although the determination is made with respect to a different taxpayer, provided that such taxpayers stand in one of the relationships specified in section 1313(c). The concept of "related taxpayer" has application to all of the circumstances of adjustment specified in § 1.1312–1 through § 1.1312–5; it does not apply in the circumstances specified in § 1.1312–6. If such relationship exists, it is not essential that the error involve a transaction made possible only by reason of the existence of the relationship. For example, if the error with respect to which an adjustment is sought under section 1311 grew out of an assignment of rents between taxpayer A and taxpayer B, who are partners, and the determination is with respect to taxpayer A, an adjustment with respect to taxpayer B may be permissible despite the fact that the assignment had nothing to do with the business of the partnership. The relationship need not exist throughout the entire taxable year with respect to which the error was made, but only at some time during that taxable year. For example, if a taxpayer on February 15 assigns to his fiancee the net rents of a building which the taxpayer owns, and the two are married before the end of the taxable year, an adjustment may be permissible if the determination relates to such rents despite the fact that they were not husband and wife at the time of the assignment. See § 1.1311 (b)–3 for the requirement in certain cases that the relationship exist at the time an inconsistent position is first maintained.

§ 1.1314(a) Statutory provisions; amount and method of adjustment; ascertainment of amount of adjustment.

SEC. 1314. *Amount and method of adjustment*—(a) *Ascertainment of amount of adjustment.* In computing the amount of an adjustment under this part there shall first be ascertained the tax previously determined for the taxable year with respect to which the error was made. The amount of the tax previously determined shall be the excess of—

(1) The sum of—

(A) The amount shown as the tax by the taxpayer on his return (determined as provided in section 6211 (b) (1) and (3), relating to the definition of deficiency), if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) The amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) The amount of rebates, as defined in section 6211 (b) (2), made.

There shall then be ascertained the increase or decrease in tax previously determined which results solely from the correct treatment of the item which was the subject of the error (with due regard given to the effect of the item in the computation of gross income, taxable income, and other matters under this subtitle). A similar computation shall be made for any other taxable year affected, or treated as affected, by a net operating loss deduction (as defined in section 172) or by a capital loss carryover (as defined in section 1212), determined with reference to the taxable year with respect to which the error was made. The amount so ascertained (together with any amounts wrongfully collected as additions to the tax or interest, as a result of such error) for each taxable year shall be the amount of the adjustment for that taxable year.

§ 1.1314(a)–1 Ascertainment of amount of adjustment in year of error.

(a) In computing the amount of the adjustment under sections 1311 to 1315, inclusive, there must first be ascertained the amount of the tax previously determined for the taxpayer as to whom the error was made for the taxable year with respect to which the error was made. The tax previously determined for any taxable year may be the amount of tax shown on the taxpayer's return, but if any changes in that amount have been made, they must be taken into account. In such cases, the tax previously determined will be the sum of the amount shown as the tax by the taxpayer upon his return and the amounts previously assessed (or collected without assessment) as deficiencies, reduced by the amount of any rebates made. The amount shown as the tax by the taxpayer upon his return and the amount of any rebates or deficiencies shall be determined in accordance with the provisions of section 6211 and the regulations thereunder.

(b) (1) The tax previously determined may consist of tax for any taxable year beginning after December 31, 1931, imposed by subtitle A of the Internal Revenue Code of 1954, by chapter 1 and subchapters A, B, D, and E of chapter 2 of the Internal Revenue Code of 1939, or by the corresponding provisions of prior internal revenue laws, or by any one or more of such provisions.

(2) After the tax previously determined has been ascertained, a recomputation must then be made under the laws applicable to said taxable year to ascertain the increase or decrease in tax, if any, resulting from the correction of the error. The difference between the tax previously determined and the tax as recomputed after correction of the error will be the amount of the adjustment.

(c) No change shall be made in the treatment given any item upon which the tax previously determined was based other than in the correction of the item or items with respect to which the error was made. However, due regard shall be given to the effect that such correction may have on the computation of gross income, taxable income, and other matters under chapter 1 of the Code. If the treatment of any item upon which the tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e. g. charitable contributions, foreign tax credit, dividends received credit, medical expenses, and percentage depletion), readjustment in these particulars will be necessary as part of the recomputation in conformity with the change in the amount of the income which results from the correct treatment of the item or items in respect of which the error was made.

(d) Any interest or additions to the tax collected as a result of the error shall be taken into account in determining the amount of the adjustment.

(e) The application of this section may be illustrated by the following example:

Example. (1) For the taxable year 1949 a taxpayer with no dependents, who kept his books on the cash receipts and disbursements method, filed a joint return with his wife disclosing adjusted gross income of $42,000, deductions amounting to $12,000, and a net income of $30,000. Included among other items in the gross income were salary in the amount of $15,000 and rents accrued but not yet received in the amount of $5,000. During the taxable year he donated $10,000 to the American Red Cross and in his return claimed a deduction of $6,300 on account thereof, representing the maximum deduction allowable under the 15-percent limitation imposed by section 23 (o) of the Internal Revenue Code of 1939 as applicable to the year 1949. In computing his net income he omitted interest income amounting to $6,000 and neglected to take a deduction for interest paid in the amount of $4,500. The return disclosed a tax liability of $7,788, which was assessed and paid. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1949, the Commissioner included the item of rental income amounting to $5,000 in the taxpayer's gross income for the year 1950 and asserted a deficiency for that year. As a result of a final decision of the Tax Court of the United States in 1955 sustaining the deficiency for 1950, an adjustment is authorized for the year 1949.

(2) The amount of the adjustment is computed as follows:

Tax previously determined for 1949	$7,788
Net income for 1949 upon which tax previously determined was based	$30,000
Less: Rents erroneously included	5,000
Balance	25,000
Adjustment for contributions (add 15 percent of $5,000)	$750
Net income as adjusted	25,750
Tax as recomputed	$6,152
Tax previously determined	7,788
Difference	1,636
Amount of adjustment to be refunded or credited	1,636

(3) In accordance with the provisions of paragraph (c) of this section, the recomputation to determine the amount of the adjustment does not take into consideration the item of $6,000 representing interest received, which was omitted from gross income, or the item of $4,500 representing interest paid, for which no deduction was allowed.

§ 1.1314(a)–2 Adjustment to other barred taxable years.

(a) An adjustment is authorized under section 1311 with respect to a taxable year or years other than the year of the error, but only if all of the following requirements are met:

(1) The tax liability for such other year or years must be affected, or must have been treated as affected, by a net operating loss deduction (as defined in section 172) or by a capital loss carryover (as defined in section 1212).

(2) The net operating loss deduction or capital loss carryover must be determined with reference to the taxable year with respect to which the error was made.

(3) On the date of the determination, the adjustment with respect to such other year or years must be prevented by some law or rule of law, other than sections 1311 through 1315 and section 7122 and the corresponding provisions of prior revenue laws.

(b) The amount of the adjustment for such other year or years shall be computed in a manner similar to that provided in § 1.1314 (a)–1. The tax previously determined for such other year or years shall be ascertained. A recomputation must then be made to ascertain the increase or decrease in tax, if any, resulting solely from the correction of the net operating loss deduction or capital loss carryover. The difference between the tax previously determined and the tax as recomputed is the amount of the adjustment. In the recomputation, no consideration shall be given to items other than the following: (1) The items upon which the tax previously determined for such other year or years was based, and (2) the net operating loss deduction or capital loss carryover as corrected. In determining the correct net operating loss deduction or capital loss carryover, no changes shall be made in taxable income (net income in the case of taxable years subject to the provisions of the Internal Revenue Code of 1939 or prior revenue laws), net operating loss or capital loss, for any barred taxable year, except as provided in section 1314. Section 172 and the corresponding provisions of prior revenue laws, and the regulations promulgated thereunder, prescribe the methods for computing the net operating loss deduction. Section 1212 and the corresponding provisions of prior revenue laws, and the regulations promulgated thereunder, prescribe the methods for computing the capital loss carryover.

(c) A net operating loss deduction or a capital loss carryover determined with reference to the year of the error may affect, or may have been treated as affecting, a taxable year with respect to which an adjustment is not prevented by the operation of any law or rule of law. In such case, the appropriate adjustment shall be made with respect to such open taxable year. However, the redetermination of the tax for such open taxable year is not made pursuant to part II (section 1311 and following), subchapter Q, chapter 1 of the Code, and the adjustment for such open year and the method of computation are not limited by the provisions of said sections.

(d) The application of this section may be illustrated by the following example:

Example. The taxpayer is a corporation which makes its income tax returns on a calendar year basis. Its net income in 1949, computed without any net operating loss

deduction was $10,000, but because of a net operating loss deduction in excess of that amount resulting from a carryback of a net operating loss claimed for 1950, it paid no income tax for 1949. On its return for 1950 it showed an excess of deductions over gross income of $14,000, and it paid no income tax for 1950. For the year 1951 its net income, computed without any net operating loss deduction, was $15,000, and a net operating loss deduction of $13,000 was allowed ($4,000 of which was attributable to the carryover from 1950 and $9,000 of which was attributable to the carryback of a net operating loss of $9,000 sustained in 1952). In 1957 the assessment of deficiencies or the allowance of refunds for all of said years are barred by the statute of limitations.

(i) A Tax Court decision entered in 1957 with respect to the taxable year 1953 constituted a determination under which an adjustment is authorized to the taxable year 1950, the year with respect to which the error was made. This adjustment increases income for said year by $15,000, so that instead of a net operating loss of $14,000, its corrected net income is $1,000 for 1950, and the tax computed on that income will be assessed as a deficiency for 1950. An adjustment is authorized under this section with respect to each of the years 1949 and 1951, as the tax liability for each year was treated as affected by a net operating loss deduction which was determined by a computation in which reference was made to the year 1950. In the recomputation of the tax for 1949, the net operating loss carryback from 1950 will be eliminated, and in the recomputation of the tax for 1951 the net operating loss carryover from 1950 will be eliminated; for each of the years 1949 and 1951 there will be an adjustment which will be treated as a deficiency for said year.

(ii) Assuming the same facts, except that the correction with respect to the year 1950 increases the net operating loss for said year from $14,000 to $20,000. As a result of this correction, there will be no change in the tax due for 1949 and 1950. However, the net operating loss deduction for 1951 is recomputed to be $19,000, the aggregate of the $10,000 carryover from 1950 and the $9,000 carryback from 1952 (the carryover from 1950 is the excess of the $20,000 net operating loss for 1950 over the $10,000 net income for 1949, such 1949 income being determined without any net operating loss deduction). As a result of the correction of the net operating loss deduction for 1951, the tax recomputation will show no tax due for said year, and the adjustment for 1951 will result in a refund or credit of the tax previously paid. Moreover, computations resulting from this adjustment will disclose a net operating loss carryover from 1952 to 1953 of $4,000, that is, the excess of the $9,000 net operating loss for 1952 over the $5,000 net income for 1951 (such net income for 1951 being computed as the $15,000 reduced by the carryover of $10,000 from 1950, the carryback from 1952 not being taken into account). A further adjustment is authorized under section 1311 with respect to any subsequent barred year in which the tax liability is affected by a carryover of the net operating loss from 1952, inasmuch as such carryover from 1952 has been determined by a computation in which reference was made to 1950, the taxable year of the error.

§ 1.1314(b) Statutory provisions; amount and method of adjustment; method of adjustment.

SEC. 1314. *Amount and method of adjustment.* • • •

(b) *Method of adjustment.* The adjustment authorized in section 1311 (a) shall be made by assessing and collecting, or refunding or crediting, the amount thereof in the same manner as if it were a deficiency determined by the Secretary or his delegate with respect to the taxpayer as to whom the error was made or an overpayment claimed by such taxpayer, as the case may be, for the taxable year or years with respect to which an amount is ascertained under subsection (a), and as if on the date of the determination one year remained before the expiration of the periods of limitation upon assessment or filing claim for refund for such taxable year or years. If, as a result of a determination described in section 1313 (a) (4), an adjustment has been made by the assessment and collection of a deficiency or the refund or credit of an overpayment, and subsequently such determination is altered or revoked, the amount of the adjustment ascertained under subsection (a) of this section shall be redetermined on the basis of such alteration or revocation and any overpayment or deficiency resulting from such redetermination shall be refunded or credited, or assessed and collected, as the case may be, as an adjustment under this part. In the case of an adjustment resulting from an increase or decrease in a net operating loss which is carried back to the year of adjustment, interest shall not be collected or paid for any period prior to the close of the taxable year in which the net operating loss arises.

§ 1.1314(b)–1 Method of adjustment.

(a) If the amount of the adjustment ascertained pursuant to § 1.1314 (a)–1 or § 1.1314 (a)–2 represents an increase in tax, it is to be treated as if it were a deficiency determined by the Commissioner with respect to the taxpayer as to whom the error was made and for the taxable year or years with respect to which such adjustment was made. The amount of such adjustment is thus to be assessed and collected under the law and regulations applicable to the assessment and collection of deficiencies, subject, however, to the limitations imposed by § 1.1314 (c)–1. Notice of deficiency, unless waived, must be issued with respect to such amount or amounts, and the taxpayer may contest the deficiency before the Tax Court of the United States or, if he chooses, may pay the deficiency and later file claim for refund. If the amount of the adjustment ascertained pursuant to § 1.1314 (a)–1 or § 1.1314 (a)–2 represents a decrease in tax, it is to be treated as if it were an overpayment claimed by the taxpayer with respect to whom the error was made for the taxable year or years with respect to which such adjustment was made. Such amount may be recovered under the law and regulations applicable to overpayments of tax, subject, however, to the limitations imposed by § 1.1314 (c)–1. The taxpayer must file a claim for refund thereof, unless the overpayment is refunded without such claim, and if the claim is denied or not acted upon by the Commissioner within the prescribed time, the taxpayer may then file suit for refund.

(b) For the purpose of the adjustments authorized by section 1311, the period of limitations upon the making of an assessment or upon refund or credit, as the case may be, for the taxable year of an adjustment shall be considered as if, on the date of the determination, one year remained before the expiration of such period. The Commissioner thus has one year from the date of the determination within which to mail a notice of deficiency in respect of the amount of the adjustment where such adjustment is treated as if it were a deficiency. The issuance of such notice of deficiency, in accordance with the law and regulations applicable to the assessment of deficiencies will suspend the running of the 1-year period of limitations provided in section 1314 (b). In accordance with the applicable law and regulations governing the collection of deficiencies, the period of limitation for collection of the amount of the adjustment will commence to run from the date of assessment of such amount. (See section 6502 and corresponding provisions of prior revenue laws.) Similarly, the taxpayer has a period of one year from the date of the determination within which to file a claim for refund in respect of the amount of the adjustment where such adjustment is treated as if it were an overpayment. Where the amount of the adjustment is treated as if it were a deficiency and the taxpayer chooses to pay such deficiency and contest it by way of a claim for refund, the period of limitation upon filing a claim for refund will commence to run from the date of such payment. See section 6511 and corresponding provisions of prior revenue laws.

(c) The amount of an adjustment treated as if it were a deficiency or an overpayment, as the case may be, will bear interest and be subject to additions to the tax to the extent provided by the internal revenue laws applicable to deficiencies and overpayments for the taxable year with respect to which the adjustment is made. In the case of an adjustment resulting from an increase or decrease in a net operating loss which is carried back to the year of adjustment, interest shall not be collected or paid for any period prior to the close of the taxable year in which the net operating loss arises.

(d) If, as a result of a determination provided for in § 1.1313 (a)–4, an adjustment has been made by the assessment and collection of a deficiency or the refund or credit of an overpayment, and subsequently such determination is altered or revoked, the amount of the adjustment ascertained under § 1.1314 (a)–1 and § 1.1314 (a)–2 shall be redetermined on the basis of such alteration or revocation, and any overpayment or deficiency resulting from such redetermination shall be refunded or credited, or assessed and collected, as the case may be, as an adjustment under section 1311. For the circumstances under which such an agreement can be altered or revoked, see paragraph (d) of § 1.1313 (a)–4.

§ 1.1314(c) Statutory provisions; amount and method of adjustment; adjustment unaffected by other items.

SEC. 1314. *Amount and method of adjustment.* • • •

(c) *Adjustment unaffected by other items.* The amount to be assessed and collected in the same manner as a deficiency, or to be refunded or credited in the same manner as an overpayment, under this part, shall not be diminished by any credit or set-off based upon any item other than the one which was the subject of the adjustment. Other than in the case of an adjustment resulting from a determination under section 1313 (a) (4), the amount of the adjustment under this part, if paid, shall not be recovered by a claim or suit for refund or suit for erroneous refund based upon any item other

than the one which was the subject of the adjustment.

§ 1.1314(c)–1 Adjustment unaffected by other items.

(a) The amount of any adjustment ascertained under § 1.1314(a)–1 or § 1.1314(a)–2 shall not be diminished by any credit or set-off based upon any item other than the one that was the subject of the adjustment.

(b) The application of this section may be illustrated by the following examples:

Example (1). In the example set forth in paragraph (c) of §1.1314 (a)–1, if, after the amount of the adjustment had been ascertained, the taxpayer filed a refund claim for the amount thereof, the Commissioner could not diminish the amount of that claim by offsetting against it the amount of tax which should have been paid with respect to the $6,000 interest item omitted from gross income for the year 1949; nor could the court, if suit were brought on such claim for refund, offset against the amount of the adjustment the amount of tax which should have been paid with respect to such interest. Similarly, the amount of the refund could not be increased by any amount attributable to the taxpayer's failure to deduct the $4,500 interest paid in the year 1949.

Example (2). Assume that a taxpayer included in his gross income for the year 1953 an item which should have been included in his gross income for the year 1952. After the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1952, the taxpayer filed a claim for refund for the year 1953 on the ground that such item was not properly includible in gross income for that year. The claim for refund was allowed by the Commissioner and as a result of such determination an adjustment was authorized under section 1311 with respect to the tax for 1952. If, in such case, the Commissioner issued a notice of deficiency for the amount of the adjustment and the taxpayer contested the deficiency before the Tax Court of the United States, the taxpayer could not in such proceeding claim an offset based upon his failure to take an allowable deduction for the year 1952; nor could the Tax Court in its decision offset against the amount of the adjustment any overpayment for the year 1952 resulting from the failure to take such deduction.

(c) If the Commissioner has refunded the amount of an adjustment under section 1311, the amount so refunded may not subsequently be recovered by the Commissioner in any suit for erroneous refund based upon any item other than the one that was the subject of the adjustment.

Example. In the example set forth in paragraph (c) of § 1.1314 (a)–1, if the Commissioner had refunded the amount of the adjustment, no part of the amount so refunded could subsequently be recovered by the Commissioner by a suit for erroneous refund based on the ground that there was no overpayment for 1949, as the taxpayer had failed to include in gross income the $6,000 item of interest received in that year.

(d) If the Commissioner has assessed and collected the amount of an adjustment under section 1311, no part thereof may be recovered by the taxpayer in any suit for refund based upon any item other than the one that was the subject of the adjustment.

Example. In example (2) of paragraph (b) of this section, if the taxpayer had paid the amount of the adjustment, he could not subsequently recover any part of such payment in a suit for refund based upon the failure to take an allowable deduction for the year 1952.

(e) If the amount of the adjustment is considered an overpayment, it may be credited, under applicable law and regulations, together with any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made such overpayment. Likewise, if the amount of the adjustment is considered as a deficiency, any overpayment by the taxpayer of any internal revenue tax may be credited against the amount of such adjustment in accordance with the applicable law and regulations thereunder. (See section 6402 and the corresponding provisions of prior revenue laws.) Accordingly, it may be possible in one transaction between the Commissioner and the taxpayer to settle the taxpayer's tax liability for the year with respect to which the determination is made and to make the adjustment under section 1311 for the year with respect to which the error was made or for a year which is affected, or treated as affected, by a net operating loss deduction or a capital loss carryover from the year of the error.

§ 1.1314(d)–(e) Statutory provisions; amount and method of adjustment; no adjustments for years prior to 1932; not applicable to tax imposed by subtitle C.

SEC. 1314. *Amount and method of adjustment.* * * *

(d) *Periods for which adjustments may be made.* No adjustment shall be made under this part in respect of any taxable year beginning prior to January 1, 1932.

(e) *Taxes imposed by subtitle C.* This part shall not apply to any tax imposed by subtitle C (sec. 3101 and following relating to employment taxes).

§ 1.1315 Statutory provisions; effective date.

SEC. 1315. *Effective date*—(a) *In general.* This part shall apply only to determinations (as defined in section 1313 (a)) made after the 90th day after the date of enactment of this title.

(b) *Transitional provision.* Notwithstanding any other provision of this title, section 3801 of the Internal Revenue Code of 1939 shall apply to determinations (as defined in subsection (a) of such section) made on or before such 90th day as if this title had not been enacted.

INVOLUNTARY LIQUIDATION AND REPLACEMENT OF LIFO INVENTORIES

§ 1.1321 Statutory provisions; involuntary liquidation of lifo inventories.

SEC. 1321. *Involuntary liquidation of lifo inventories*—(a) *Adjustment of taxable income and resulting tax.* If, for any taxable year ending after June 30, 1950, and before January 1, 1955, the closing inventory of a taxpayer inventorying goods under the method provided in section 22 (d) of the Internal Revenue Code of 1939 reflects a decrease from the opening inventory of such goods for such year, and if the taxpayer elects, at such time and in such manner and subject to such regulations as the Secretary or his delegate may prescribe, to have this section apply, and if it is established to the satisfaction of the Secretary or his delegate, in accordance with such regulations, that such decrease is attributable to the involuntary liquidation of such inventory as defined in section 22 (d) (6) (B) of the Internal Revenue Code of 1939 (as modified by subsection (b) of this section), and if the closing inventory of a subsequent taxable year, ending before January 1, 1956, reflects a replacement, in whole or in part, of the goods so previously liquidated, then the taxable income of the taxpayer otherwise determined for the year of such involuntary liquidation shall be increased by an amount equal to the excess, if any, of the aggregate cost of such goods reflected in the opening inventory of the year of involuntary liquidation over the aggregate replacement cost, or decreased by an amount equal to the excess, if any, of the aggregate replacement cost of such goods over the aggregate cost thereof reflected in the opening inventory of the year of the involuntary liquidation. The taxes imposed by this chapter (and by chapters 1 and 2 of the Internal Revenue Code of 1939) for the year of such liquidation, for preceding taxable years, and for all taxable years intervening between the year of liquidation and the year of replacement shall be redetermined, giving effect to such adjustments. Any increase in such taxes resulting from such adjustments shall be assessed and collected as a deficiency but without interest, and any overpayment so resulting shall be credited or refunded to the taxpayer without interest.

(b) *Definitions.* For purposes of this section, the term "involuntary liquidation" shall have the meaning given to it in section 22 (d) (6) (B) of the Internal Revenue Code of 1939 and, in addition, it shall mean a failure, as referred to in that section, on the part of the taxpayer due, directly and exclusively, to disruption of normal trade relations between countries. For purposes of this section, the words "enemy" and "war", as used in such section 22 (d) (6) (B), shall be interpreted, pursuant to regulations prescribed by the Secretary or his delegate, in such a way as to apply to circumstances, occurrences and conditions, lacking a state of war, which are similar, by reason of a state of national preparedness, to those which would exist under a state of war.

(c) *Special rules.* Subparagraphs (C) and (E) of section 22 (d) (6) of the Internal Revenue Code of 1939, to the extent that they refer to any taxpayer subject to subparagraph (A) of such section or to the adjustments specified in or resulting from the effect of subparagraph (A) of such section, shall apply to a taxpayer subject to this section or to adjustments specified in or resulting from the effect of this section as though they specifically referred to this section. If, for any taxable year ending after June 30, 1950, and before January 1, 1953, subparagraph (C) of such section 22 (d) (6) applies with respect to involuntary liquidations of goods of the same class subject to both subparagraph (A) of such section and to this section, the involuntary liquidations of such goods subject to this section shall be considered for the purpose of such subparagraph (C) as having occurred before the involuntary liquidations of such goods subject to subparagraph (A) of such section 22 (d) (6). For the purpose of this subsection, and with respect to the taxable years covered by this section, the reference in subparagraph (E) of such section 22 (d) (6) to section 734 (d) shall be taken as a reference to section 452 (d) of the Internal Revenue Code of 1939, and, with respect to any taxable year to which any provision of the Internal Revenue Code of 1939 may not be applicable, references in such subparagraph to such provision shall, where applicable, be deemed a reference to the corresponding provision of the Internal Revenue Code of 1954.

§ 1.1321–1 Involuntary liquidation of life inventories.

(a) Section 22(d)(6)(B) of the Internal Revenue Code of 1939 provides as follows:

Sec. 22. Gross Income. * * *
(d) * * *

(c) *Involuntary liquidation and replace-*

(c) *Involuntary liquidation and replacement of inventory.* * * *

(B) *Definition of involuntary liquidation.* The term "involuntary liquidation", as used in this paragraph, means the sale or other disposition of goods inventoried under the method described in this subsection, either voluntary or involuntary, coupled with a failure on the part of the taxpayer to purchase, manufacture, or otherwise produce and have on hand at the close of the taxable year in which such sale or other disposition occurred such goods as would, if on hand at the close of such taxable year, be subject to the application of the provisions of this subsection, if such failure on the part of the taxpayer is due, directly and exclusively, (i) to enemy capture or control of sources of limited foreign supply; (ii) to shipping or other transportation shortages; (iii) to material shortages resulting from priorities or allocations; (iv) to labor shortages; or (v) to other prevailing war conditions beyond the control of the taxpayer.

(b) (1) If, during any taxable year ending after June 30, 1950, and before January 1, 1955, the disruption of normal trade relations between countries, or one or more of the conditions attributable to a state of national preparedness and beyond the control of the taxpayer, as prescribed by section 22 (d) (6) (B) of the Internal Revenue Code of 1939, as modified by section 1321 (b) of the Internal Revenue Code of 1954, should render it impossible during such period for a taxpayer using the last-in first-out inventory method to have on hand at the close of the taxable year a stock of merchandise in kind and description like that included in the opening inventory for the year, or in a quantity equal to that of the opening inventory, the resulting inventory decrease for the year will be regarded, at the election of the taxpayer, as reflecting an involuntary liquidation subject to replacement. If the taxpayer notifies the Commissioner within the period prescribed below that he intends to effect a replacement of the liquidated stock, in whole or in part, and that he desires to have applied in his case the involuntary liquidation and replacement provisions of section 1321, and if he establishes to the satisfaction of the Commissioner the involuntary character of the liquidation to which his stock has been subjected, effect shall be given, when replacement has been made, in whole or in part, but only to the extent made in taxable years ending before January 1, 1956, to an adjustment of taxable income for the year of liquidation in the amount of the difference between the replacement costs incurred and the original inventory cost of the liquidated base stock inventory that is replaced. The notification is to be given within 6 months after the filing by the taxpayer of his income tax return for the year of the liquidation. However, if the liquidation occurs in a taxable year ending after December 31, 1953, the notification may be given at any time within 3 months after the promulgation of regulations under section 1321, or prior to the expiration of the 6-month period following the filing of the return, whichever expiration date later occurs.

(2) If the replacement costs exceed such inventory costs, the taxable income of the taxpayer otherwise computed for the year of liquidation shall be reduced by an amount equal to such excess. If the replacement costs are less than the inventory costs, taxable income otherwise computed for the year of liquidation shall be increased to the extent of such difference. Any deficiency in the income or excess profits tax of the taxpayer, or any overpayment of such taxes, attributable to such adjustment shall be assessed and collected or credited or refunded to the taxpayer without interest.

(c) (1) A failure on the part of the taxpayer to have on hand in his closing inventory for the taxable year merchandise of the kind, description, and quantity of that reflected in his opening inventory will be considered as an involuntary liquidation only if it is established to the satisfaction of the Commissioner that such failure is due wholly to his inability to purchase, manufacture, or otherwise produce and procure delivery of such merchandise during the taxable year of liquidation by reason of the disruption of normal trade relations between countries or by reason of certain war conditions, described in section 22 (d) (6) (B) of the Internal Revenue Code of 1939, as modified by section 1321 (b). Such war conditions are (i) shortages in the source of foreign supply by reason of capture or control by an enemy; (ii) shipping or other transportation shortages; (iii) material shortages resulting from priorities or allocations; (iv) labor shortages; and (v) similar war conditions beyond the control of the taxpayer. For the purpose of the preceding sentence, the words "enemy" and "war" shall be interpreted to apply to circumstances, occurrences, and conditions lacking a state of war, which are similar, by reason of a state of national preparedness, to those which would exist under a state of war.

(2) The various directives, orders, regulations, and allotments issued by the Federal Government in connection with national preparedness are among such circumstances and conditions which might be recognized as effecting an involuntary liquidation under this section. Likewise, a voluntary compliance with a request of an authorized representative of the Federal Government made upon an industry or an important segment thereof, or a voluntary allocation of materials by an industry or important segment thereof sanctioned by the Federal Government, if made in connection with the national preparedness program, might be considered as such a circumstance or condition. Similarly, so much of an inventory decrease as is directly and exclusively attributable to the Federal Government's stockpiling program for periods during which an item is not subject to allotment shall also be considered as subject to the provisions of section 1321. Thus, so much of an inventory decrease as is due wholly to the effect of directives, orders, regulations, or allotments issued pursuant to the Defense Production Act of 1950, as amended (50 U.S.C. App. 2061 et seq.), or to any other circumstance or condition which is solely dependent upon other action taken by the Federal Government in furtherance of the national preparedness program, ordinarily shall be considered as an involuntary liquidation under section 1321 and this section; however, to the extent that such a decrease is due to the disposition of goods acquired in violation of such directives, orders, regulations, or allotments, such decrease shall not be considered as such an involuntary liquidation. An inventory decrease due directly and exclusively to a disruption of normal trade relations between countries shall be considered as an involuntary liquidation subject to the rules and requirements prescribed in this section, including the requirement that the taxpayer establish to the satisfaction of the Commissioner the cause of the involuntary liquidation. A disruption of normal trade relations between countries may be reflected by unusual export limitations imposed by a foreign government, by unusual exchange restrictions, or by other unusual circumstances or conditions beyond the control of the taxpayer.

(3) A voluntary shift by the taxpayer, in the exercise of business judgment, to merchandise of a different character, description, or use, or to merchandise processed out of a substantially different kind of raw materials while raw materials of the type originally used are still available will not be considered as an involuntary liquidation notwithstanding the fact that such a shift in merchandise stocked was prompted by a shifting market demand attributable to the above conditions. The term "involuntary liquidation" presupposes a physical inability to maintain a normal inventory as distinguished from a financial or business disinclination on the part of the taxpayer to do so.

(d) If the taxpayer would have the involuntary liquidation and replacement provisions applicable with respect to any inventory decrease, he must so elect within the time prescribed by this section. In making such election, the taxpayer shall attach to his return and make a part thereof, or he shall furnish separately to the Commissioner, a statement setting forth the following matters: (1) The desire of the taxpayer to invoke the involuntary liquidation and replacement provisions; (2) a detailed list or other identifying description of the items of merchandise claimed to have been subjected to involuntary liquidation and the extent to which replacement is intended; (3) the circumstances relied upon as rendering the taxpayer unable to maintain throughout the taxable year a normal inventory of the items involved, including evidence of the applicable inventory control figures for the beginning and the close of the taxable year submitted to the appropriate Federal agency in control of defense production (or if none, a statement to that effect), allotments applied for, allotments received, and reason for failure to place allotments received; (4) detailed proof of such circumstances to the extent that they may not be the subject-matter of common knowledge; (5) a full description of what efforts were made on the part of the taxpayer to effect replacement during the taxable year and the result of such efforts; and (6) in the case of an election made pursuant to an extension of time granted

by the Commissioner, the circumstances relied upon as justifying the election at such time, together with a disclosure of the extent, if any, to which replacements have already been made.

(e) The election of the taxpayer to treat an involuntary decrease of inventory as subject to the replacement adjustments is to be exercised separately for each taxable year reflecting such a decrease and the election, once exercised with respect to a given year, shall be irrevocable with respect to the particular decrease involved and its replacement, and shall be binding for the year of liquidation, the year of replacement, and all prior, intervening, and subsequent years to the extent that such prior, intervening, and subsequent years are affected by the adjustments authorized. The ultimate replacement and the resulting adjustment for the year of liquidation may have consequences, among others, in the earnings and profits of intervening years and the inventory accounts of subsequent years. They may have consequences in the prior years by reason of adjustments in net operating loss or unused excess profits credit carrybacks, and in intervening and subsequent taxable years by reason of adjustments in carryovers. Adjustments are to be made for the several years affected consistent with the adjustments made for the year of liquidation. Detailed records shall be maintained such as will enable the Commissioner, in his examination of the taxpayer's return for the year of replacement, readily to verify the extent of the inventory decrease claimed to be involuntary in character and the facts upon which such claim is based, all subsequent inventory increases and decreases, and all other facts material to the replacement adjustment authorized. For taxable years subject to the Internal Revenue Code of 1939, an election under 26 CFR (1939) 39.22(d)–7(e) (Regulations 118) or 26 CFR (1939) 29.22(d)–7 (Regulations 111) to have the involuntary liquidation and replacement provisions of section 22(d)(6) of the Internal Revenue Code of 1939 apply with respect to any inventory decrease for taxable years to which such section applies, shall be given the same effect as if such election had been made under this section. (See section 7807 (b) (2).)

(f) Notwithstanding the ultimate purchase price or the cost of production ultimately incurred by the taxpayer in effecting replacement of a stock involuntarily liquidated, the merchandise reflecting the replacement shall be taken into purchases and included in the closing inventory for the year of replacement, and shall be included in the inventories of subsequent taxable years, at the inventory cost figure of the merchandise replaced.

(g) The goods reflected in any inventory increase in a year subsequent to a year of involuntary liquidation, to the extent that they constitute items of the kind and description liquidated in prior years, whether or not in a year of involuntary liquidation, shall be deemed, in the order of their acquisition, as having been acquired by the taxpayer in replacement of like goods most recently liquidated and not previously replaced. In a case involving involuntary liquidations of goods of the same class subject to the provisions of both section 22 (d) (6) (A) of the Internal Revenue Code of 1939 and section 1321 of the Internal Revenue Code of 1954, the involuntary liquidations of such goods subject to the provisions of section 1321 shall, for the purpose of replacements made in taxable years ending before January 1, 1953, be considered as having occurred prior to the involuntary liquidations of such goods subject to the provisions of section 22 (d) (6) (A) of the Internal Revenue Code of 1939. To the extent that the items of increase are allocated to items liquidated voluntarily, no adjustment will be required or permitted. Such replacement merchandise will be carried in the inventory at its actual cost of acquisition. To the extent that replacements are allocated to items involuntarily liquidated, however, the provisions of this section shall apply, both with respect to adjustments for the year of liquidation and other taxable years affected and with respect to inventory computations for the year of replacement and all subsequent taxable years.

(h) In some cases it may appear that, at the time of the filing of the income tax return for the year of replacement, or within three years thereafter, an adjustment with respect to the income or excess profits taxes for the year of the involuntary liquidation, or for some prior, intervening, or subsequent taxable year, is prevented by the running of the statute of limitations, by the execution of a closing agreement, by virtue of a court decision which has become final, or by reason of some other provision or rule of law other than section 7122 (relating to compromises) and other than the inventory replacement provisions. The adjustments provided for in connection with the involuntary liquidation and replacement of inventory shall nevertheless be made, but only if, within a period of three years after the date of the filing of the income tax return for the year of replacement, a notice of deficiency is mailed or a claim for refund is filed. No credit or refund will be allowed under such circumstances, whether within or without such three-year period, in the absence of a claim for refund duly filed; nor will a resulting deficiency be assessed or collected under section 6213 (d) relating to waivers of restrictions. The issuance of the statutory notice of deficiency or the filing of a claim for refund are statutory conditions upon which depend the provisions of section 22 (d) (6) (E) of the Internal Revenue Code of 1939, referred to in section 1321 (c) of the Internal Revenue Code of 1954. The adjustment authorized by section 22 (d) (6) (E) of the Internal Revenue Code of 1939 is limited further to the tax attributable solely to the replacement adjustments. The amount of the adjustment shall be computed by reference to the amount of the tax previously determined, and without regard to factors affecting the taxable year involved to which no effect was given in such prior determination. The tax previously determined shall be ascertained in accordance with the principles stated in section 452 (d) of the Internal Revenue Code of 1939. Any deficiency paid or any overpayment credited or refunded under these circumstances shall not be subject to recovery on a claim for refund or a suit for the recovery of an erroneous refund in any case in which such claim or suit is based upon factors other than those giving rise to the adjustments made.

§ 1.1321–2 Liquidation and replacement of lifo inventories by acquiring corporations.

For additional rules in the case of certain corporate acquisitions referred to in section 381(a), see section 381 (c)(5) and the regulations thereunder.

War Loss Recoveries

§ 1.1331 Statutory provisions; war loss recoveries.

SEC. 1331. *War loss recoveries.* On the recovery in the taxable year of any money or property in respect of property considered under section 127 (a) of the Internal Revenue Code of 1939, as destroyed or seized, the amount of such recovery shall be included in gross income to the extent provided in section 1332, unless section 1333 applies to the taxable year pursuant to an election made by the taxpayer under section 1335.

§ 1.1331–1 Recoveries in respect of war losses.

(a)(1) The amount of any recovery in respect of "war loss property" must be included in gross income to the extent provided in section 1332 unless, pursuant to the taxpayer's election under section 1335, the provisions of section 1333 are applicable to such recovery. For the treatment of war loss recoveries under section 1333 and the manner of making the election under section 1335, see §§ 1.1333–1 and 1.1335–1.

(2) As used in this part, the term "war loss property" means property considered under section 127 (a) of the Internal Revenue Code of 1939 as "destroyed or seized", including any interest described in section 127 (a) (3) of the Internal Revenue Code of 1939.

(3) For regulations governing the treatment of war losses under the Internal Revenue Code of 1939, see 26 CFR (1939) 29.127(a)–1 to 29.127(a)–4, inclusive, 29.127(b)–1, and 29.127(e)–1 (Regulations 111) and 26 CFR (1939) 39.127(a)–1 (Regulations 118).

(b) The recoveries in respect of any war loss property include the recovery of the same war loss property and the recovery of any money or property in lieu of such property or on account of the destruction or seizure of such property. For example, there is a recovery upon the return to the taxpayer after the termination of the war of his property which was treated as war loss property because it was located in a country at war with the United States. An award by a government on account of the seizure of the taxpayer's property by an enemy country is a recovery under this section. The amount obtained upon the sale or other transfer by the taxpayer of his right to any war loss property is also a recovery for the purpose of this section. Simi-

larly, if a taxpayer who sustained a war loss upon the liquidation of a corporation has received the rights to any property of the corporation which was treated as war loss property, any recovery by the taxpayer with respect to such rights is a recovery by him for the purposes of this section.

(c) For the purpose of this section, the recoveries considered are only those with respect to war losses sustained in prior taxable years. Similarly, the only deductions considered are those allowable for prior taxable years, and any allowable deductions for the year of the recovery are ignored for the purposes of applying such section to the recovery.

(d) If a deduction was claimed under section 127 (a) of the Internal Revenue Code of 1939 by a taxpayer in computing his tax for any taxable year and if such deduction was disallowed in whole or in part, any recovery in respect of the portion disallowed shall not be subject to the provisions of part IV (section 1331 and following), subchapter Q, chapter 1 of the Code.

§ 1.1332 Statutory provisions; inclusion in gross income of war loss recoveries.

SEC. 1332. *Inclusion in gross income of war loss recoveries*—(a) *Amount of recovery.* The amount of the recovery of any money or property in respect of property considered under section 127 (a) of the Internal Revenue Code of 1939, as destroyed or seized, shall be an amount equal to the aggregate of such money and the fair market value of such property, determined as of the date of the recovery.

(b) *Amount of gain includible*—(1) *Portion excluded from gross income.* To the extent that the amount of the recovery plus the aggregate of the amounts of previous such recoveries do not exceed that part of the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of property described in such section 127 (a) which did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of the Internal Revenue Code of 1939, such amount shall not be includible in gross income and shall not be deemed gain on the involuntary conversion of property as a result of its destruction or seizure.

(2) *Portion treated as ordinary income.* To the extent that such amount plus the aggregate of the amounts of previous such recoveries exceed that part of the aggregate of such deductions, which did not result in a reduction of any tax of the taxpayer under such chapters and do not exceed that part of the aggregate of such deductions which did result in a reduction of any tax of the taxpayer under such chapters, such amount shall be included in gross income but shall not be deemed a gain on the involuntary conversion of property as a result of its destruction or seizure.

(3) *Portion treated as gain on involuntary conversion.* To the extent that such amount plus the aggregate of the amounts of previous such recoveries exceed the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of property described in such section 127 (a), such amount shall be considered a gain on the involuntary conversion of property as a result of its destruction or seizure and shall be recognized or not recognized as provided in section 1033 (relating to involuntary conversions).

(4) *Obligations not discharged.* If for any previous taxable year the taxpayer chose under section 127 (b) of the Internal Revenue Code of 1939 to treat any obligations and liabilities as discharged or satisfied out of the property or interest described in such section 127 (a), and if such obligations and liabilities were not so discharged or satisfied, the amount of such obligations and liabilities treated as discharged or satisfied under such section 127 (b) shall be considered for purposes of this part as a deduction by reason of such section 127 (a) which did not result in a reduction of any tax of the taxpayer under such chapters 1 or 2.

(5) *Allowable deduction not allowed.* For purposes of this subsection, an allowable deduction for any taxable year on account of the destruction or seizure of property described in such section 127 (a) shall, to the extent not allowed in computing the tax of the taxpayer for such taxable year, be considered an allowable deduction which did not result in a reduction of any tax of the taxpayer under such chapters 1 or 2.

§ 1.1332–1 Inclusion in gross income of war loss recoveries.

(a) *Amount of recovery.* Except as provided in section 1333(1), the amount of the recovery in respect of a war loss in a previous taxable year is determined in the same manner for the purpose of either section 1332 or 1333. The amount of the recovery of any money or property in respect of any war loss is the aggregate of the amount of such money and of the fair market value of such property, both determined as of the date of the recovery. But see paragraph (a) of § 1.1333–1 for optional valuation where the taxpayer recovers the same war loss property.

(b) *Amount of gain includible.* (1) A taxpayer who has sustained a war loss described in section 127 (a) of the Internal Revenue Code of 1939 and who has not elected to have the provisions of section 1333 apply to any taxable year in which he recovered any money or property in respect of a war loss in any previous taxable year must include in his gross income for each taxable year, to the extent provided in section 1332, the amount of his recoveries of money and property for such taxable year in respect of any war loss in a previous taxable year. Section 1332 provides that such recoveries for any taxable year are not includible in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of such war losses which did not result in a reduction of any tax under chapter 1 or 2 of the Internal Revenue Code of 1939. War loss recoveries are considered as made first on account of war losses allowable but not actually allowed as a deduction, and second on account of war losses allowed as a deduction but which did not result in a reduction of tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. If there were deductions allowed on account of war losses for two or more taxable years which did not result in a reduction of any tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939, a recovery on account of such losses is considered as made on account of such losses in the order of the taxable years for which they were allowed beginning with the latest. See § 1.1337–1 for the determination of the amount of such deductions. Recoveries in excess of such amount are treated as ordinary income until such excess equals the amount of the taxpayer's allowable deductions in prior taxable years on account of war losses which did result in a reduction of any such tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. Any further recoveries in excess of all the taxpayer's allowable deductions in prior taxable years for war losses are treated as gain on an involuntary conversion of property as a result of its destruction or seizure, and such gain is recognized or not recognized under the provisions of section 1033. See section 1033 and the regulations thereunder. Such gain, if recognized, is included in gross income as ordinary income unless section 1231 (a) applies to cause such gain to be treated as gain from the sale or exchange of a capital asset held for more than six months. See section 1231 (a) and the regulations thereunder.

(2) The determination as to whether and to what extent any recoveries are to be included in gross income is made upon the basis of the amount of all the recoveries for each day upon which there are any such recoveries, as follows:

(i) The amount of the recoveries for any day is not included in gross income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of the allowable deductions in prior taxable years on account of war losses which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code of 1939, as determined under § 1.1337–1, exceeds the amount of all previous recoveries in the same and prior taxable years.

(ii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income as ordinary income, and is not considered gain on an involuntary conversion, to the extent, if any, that the aggregate of all the allowable deductions in prior taxable years on account of war losses (both those which resulted in a reduction of a tax of the taxpayer and those which did not) exceeds the sum of the amount of all previous recoveries in the same and prior taxable years and of that portion, if any, of the amount of the recoveries for such day which is not included in gross income under subdivision (i) of this subparagraph.

(iii) The amount of the recoveries for any day which is not excluded from gross income under subdivision (i) of this subparagraph and is not included in gross income as ordinary income under subdivision (ii) of this subparagraph is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions then apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 1033, relating to gain on the involuntary conversion of property. For the purpose of applying section 1033, such gain for any day is deemed to be expended in the manner provided in section 1033 to the extent the recovery for such day is so expended.

(*b*) If such gain is recognized, it is included in gross income as ordinary in-

come or, if the provisions of section 1231 (a) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. For the purpose of applying section 1231 (a), such recognized gain for any day is deemed to be derived from property described in that section to the extent of the recovery for such day with respect to such property, except such portion of such recovery as is attributable to the nonrecognized gain for such day.

(c) Section 1336 provides that in determining the unadjusted basis of recovered property, the total gain and the recognized gain with respect to such property must be determined. For such purpose, the recognized gain deemed to be derived from properties described in section 1231 (a) may be allocated among such properties in the proportion of the recoveries with respect to such properties, reduced for each property by the portion of the recovery attributable to the nonrecognized gain for such day, and the recoveries with respect to properties not described in section 1231 (a) may be similarly allocated. The total gain derived from any recovered property is the sum of the nonrecognized gain attributable to the recovery of such property and of the recognized gain allocable to such property.

(3) The foregoing provisions may be illustrated by the following examples:

Example (1). The taxpayer sustained war losses of $3,000 on account of properties A, B, C, and D. Of this amount, $1,000 did not result in a reduction of any income tax of the taxpayer, as determined under the provisions of § 1.1337–1. In a subsequent taxable year, he received an award of $800 from the Government on account of property A. This is not included in income since it is less than the amount by which his allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) exceed $0, the sum of all his previous recoveries. On a later date the taxpayer recovers property B, which is worth $1,500 on the date of recovery. This recovery is not included in gross income to the extent of $200, the amount by which the aggregate of the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) exceeds the sum of all previous recoveries ($800). The remaining $1,300 of the recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, since it is less than the amount by which the aggregate of all the allowable deductions in prior taxable years on account of war losses ($3,000) exceeds $1,000, the sum of the $800 of previous recoveries and of the $200 portion of the recovery with respect to B which is not included in gross income. On a still later date the taxpayer sells for $2,500 his rights to recover C. Since the allowable deductions for prior taxable years on account of war losses which did not result in any tax benefit ($1,000) do not exceed the previous recoveries by the taxpayer ($800 and $1,500, or $2,300), none of the recovery on account of C is excluded from gross income. This recovery is included in gross income as ordinary income, and is not considered gain on the involuntary conversion of property, to the extent of $700, the amount by which the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) exceeds $2,300, the sum of the $2,300 of previous recoveries and of the $0 portion of the recovery on account of C which is not included in gross income. The remaining $1,800 of the recovery is considered gain on an involuntary conversion of property on account of its destruction or seizure, and is not recognized if forthwith expended in the manner provided in section 1033. Thus, it is not recognized if it is forthwith expended for the acquisition of property related in service or use to C. On a later date the taxpayer recovers D, which has a fair market value of $400 at the time of the recovery. Since the aggregate of all the allowable deductions for prior taxable years on account of war losses ($3,000) does not exceed the previous recoveries by the taxpayer ($800+$1,500+$2,500, or $4,800), all of the recovery with respect to D is considered gain on an involuntary conversion of property as a result of its destruction or seizure. Under the provisions of section 1033, this gain is not recognized if D is used for the same purposes for which it was used before it was deemed destroyed or seized under section 127 (a) of the Internal Revenue Code of 1939.

Example (2). The taxpayer on one day recovers $3,000 for property A and $7,000 for property B, both of which were treated as war loss property for a prior taxable year, and $8,000 of such $10,000 recoveries is considered gain on the involuntary conversion of property as a result of its destruction or seizure. The taxpayer forthwith expends $5,000 in the acquisition of property similar in use to B. Therefore, $5,000 of the $8,000 gain is not recognized under section 1033, leaving $3,000 of recognized gain. Property B is within the provisions of section 1231 (a), relating to gains and losses on the involuntary conversion of certain described property, but property A is not. Therefore, the provisions of section 1231 (a) apply to $2,000 of the $3,000 gain, that is, the amount of the recovery with respect to B which is not attributable to the nonrecognized gain for such day ($7,000 minus $5,000). If the taxpayer forthwith expended $8,000 or more for the acquisition of property similar in use to B, none of the gain would be recognized. If the taxpayer forthwith expended the $5,000 to acquire property related in use to A, the $3,000 recognized gain would be considered derived from B to the extent of the recovery with respect to B ($7,000), not reduced by any nonrecognized gain since none of such recovery is attributable to such nonrecognized gain, and therefore all of the $3,000 recognized gain would be subject to the provisions of section 1231 (a).

(4) An allowable deduction with respect to a war loss is any deduction to which the taxpayer is entitled on account of any war loss property, regardless of whether or not such deduction was claimed by the taxpayer or otherwise allowed in computing his tax. If a deduction was claimed by a taxpayer in computing his tax for any taxable year and if such deduction was disallowed, such deduction will not be considered an allowable deduction for such taxable year since the previous determination will not be reconsidered.

§ 1.1333 Statutory provisions; tax adjustment measured by prior benefits.

SEC. 1333. *Tax adjustment measured by prior benefits.* If this section applies to the taxable year pursuant to an election made by the taxpayer under section 1335 or section 127 (c) (5) of the Internal Revenue Code of 1939—

(1) *Amount of recovery.* The amount of the recovery in the taxable year of any money or property in respect of property considered under section 127 (a) of the Internal Revenue Code of 1939 as destroyed or seized, shall be an amount equal to the aggregate of such money and the fair market value of such property, determined as of the date of the recovery. For purposes of this section, in the case of the recovery of the same property or interest considered under such section 127 (a) as destroyed or seized, the fair market value of such property or interest shall, at the option of the taxpayer, be considered an amount equal to the adjusted basis (for determining loss) of such property or interest in the hands of the taxpayer on the date such property or interest was considered under such section 127 (a) as destroyed or seized. The amount of the recovery determined under this paragraph shall be reduced for purposes of paragraphs (2) and (3) by the amount of the obligations or liabilities with respect to the property considered under such section 127 (a) as destroyed or seized in respect of which the recovery was received, if the taxpayer for any previous taxable year chose under section 127 (b) (2) of such code to treat such obligations or liabilities as discharged or satisfied out of such property, and such obligations or liabilities were not so discharged or satisfied before the date of the recovery.

(2) *Adjustment for prior tax benefits.* That part of the amount of the recovery, in respect of any property considered under such section 127 (a) as destroyed or seized, which is not in excess of the allowable deductions in prior taxable years on account of such destruction or seizure of the property (the amount of such allowable deductions being first reduced by the aggregate amount of any prior recoveries in respect of the same property) shall be excluded from gross income for the taxable year of the recovery for purposes of computing the tax under this subtitle; but there shall be added to, and assessed and collected as a part of, the tax under this subtitle for the taxable year of the recovery the total increase in the tax under chapters 1 and 2 of the Internal Revenue Code of 1939 for all taxable years which would result by decreasing, in an amount equal to such part of the recovery so excluded, such deductions allowable in the prior taxable years with respect to the destruction or seizure of the property. Such increase in the tax for each such year so resulting shall be computed in accordance with regulations prescribed by the Secretary or his delegate. Such regulations shall give effect to previous recoveries of any kind (including recoveries described in section 111, relating to recovery of bad debts, etc.) with respect to any prior year, and shall provide for the case where there was no tax for the prior year, but shall otherwise treat the tax previously determined for any year in accordance with the principles set forth in section 1314 (a) (relating to corrections of errors). All credits allowable against the tax for any year and all carryovers and carrybacks affected by so decreasing the allowable deductions shall be taken into account in computing the increase in the tax, except that the computation of the excess profits credit under chapter 2 E of such code for any taxable year shall not be affected.

(3) *Gain on recovery.* The amount of any recovery or part thereof, in respect of property considered under such section 127 (a) as destroyed or seized, which is not excluded from gross income under paragraph (2), shall be considered for the taxable year of the recovery as gain on the involuntary conversion of property as a result of its destruction or seizure and shall be recognized or not recognized as provided in section 1033.

(4) *Recoveries treated as gross income for certain purposes.* For purposes of section 6012 (relating to persons required to make income tax returns) and section 1312 (relating to circumstances of adjustment), the recovery in the taxable year of any money or property in respect of property considered under such section 127 (a) as destroyed or seized in any prior taxable year shall be deemed to be an item includible in gross income for the taxable year in which the recovery is made.

§ 1.1333–1 Tax adjustment measured by prior benefits.

(a) *Amount of recovery.* The amount of recovery for purposes of this section shall be determined in accordance with the provisions of section 1332(a). See paragraph (a) of § 1.1332–1. If, pursuant to the taxpayer's election under section 1335, the provisions of section 1333 are applicable to any taxable year in which he recovers the same war loss property, the fair market value of such property shall, at the option of the taxpayer, be considered an amount equal to the adjusted basis (for determining loss) of such property in the hands of the taxpayer on the date such property was considered as destroyed or seized. This option is exercisable by the taxpayer with respect to each separate war loss property. Also, if the provisions of section 1333 are applicable pursuant to the taxpayer's election, the amount of the recovery of any money or property in respect of war loss property shall be reduced for the purpose of section 1333 (2) and (3) by the amount of the obligations or liabilities with respect to such property, if the taxpayer for any previous taxable year chose under section 127 (b) (2) of the Internal Revenue Code of 1939 to treat such obligations or liabilities as discharged or satisfied out of such property, and such obligations or liabilities were not so discharged or satisfied before the date of the recovery. See 26 CFR (1939) 29.127(b)–1 (Regulations 111).

(b) *Elective method; tax adjustment measured by prior benefits.* (1) If the taxpayer elects pursuant to section 1335 and in accordance with the provisions of § 1.1335–1 to have the provisions of section 1333 apply to any taxable year in which he recovers any money or property in respect of war loss property, the amount of the recovery in respect of such property for any taxable year shall not be included in income until the taxpayer has recovered an amount equal to his allowable deductions in prior taxable years on account of the destruction or seizure of such property, whether or not such allowable deductions resulted in a reduction of any tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. However, for the purposes of section 6012 (a) (1), relating to the requirement of individual returns, section 6012 (a) (2), relating to the requirement of corporation returns, and section 1312, relating to the mitigation of the effect of the statute of limitations, the entire amount of the recovery shall be deemed to be an item includible in gross income for the taxable year in which the recovery is made. In lieu of including such amount in gross income, there shall be added to, and assessed and collected as a part of, the tax imposed under subtitle A of the Internal Revenue Code of 1954 for the taxable year of the recovery an adjustment on account of any tax benefits in all prior taxable years resulting directly or indirectly from the fact that the loss from the destruction or seizure of such property was an allowable deduction. The amount of such adjustment shall be the total increase in the tax under chapters 1 and 2 of the Internal Revenue Code of 1939 for all taxable years which would result by decreasing such allowable deductions with respect to the destruction or seizure of such property by an amount equal to that portion of the amount of the recovery which is not included in gross income for the taxable year of the recovery. The portion of the amount of the recovery which is in excess of such allowable deductions is included in gross income for the taxable year of the recovery as gain on the involuntary conversion of property as a result of its destruction or seizure and is recognized or not recognized as provided in section 1033. See section 1033 and the regulations thereunder. Such gain, if recognized, is included in gross income as ordinary income unless section 1231 (a) applies to cause such gain to be treated as gain on the sale or exchange of capital assets held for more than six months. See section 1231 (a) and the regulations thereunder.

(2) The determination as to whether and to what extent the amount of the recovery is to be excluded from gross income is to be made upon the basis of the total amount of the recoveries in each taxable year in respect of the same war loss property, as follows:

(i) The amount of the recovery in any taxable year is excluded from the gross income of such year and is not considered gain on an involuntary conversion to the extent that such amount does not exceed the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of such property (whether or not such deductions resulted in a reduction of a tax of the taxpayer) reduced by the aggregate amount of any recoveries in intervening taxable years in respect of the same property.

(ii) The amount of the recovery in any taxable year which is not excluded from gross income under subdivision (i) of this subparagraph is included in gross income and is considered gain on an involuntary conversion of property as a result of its destruction or seizure. The following provisions apply to this gain:

(*a*) Such gain is recognized or not recognized under the provisions of section 1033, relating to gain on the involuntary conversion of property. For the purpose of applying section 1033, such gain for any taxable year is deemed to be expended in the manner provided in section 1033 to the extent the recovery in such taxable year is so expended.

(*b*) If such gain is recognized it is included in gross income as ordinary income or, if the provisions of section 1231 (a) apply and require such treatment, as gain on the sale or exchange of a capital asset held for more than six months. In the case of the recovery of the same war loss property, any gain will not be deemed to be recognized under the provisions of section 1231 (a) if such property is used for the same purpose for which it was used before it was deemed destroyed or seized under section 127 (a) of the Internal Revenue Code of 1939.

(3) The determination of the total increase in the tax under chapters 1 and 2 of the Internal Revenue Code of 1939 for all taxable years which would result by decreasing the deductions allowable in any prior taxable year with respect to the destruction or seizure of the property in respect of which the taxpayer has made a recovery by an amount equal to the part of such recovery not included in gross income for the taxable year of such recovery shall be made as provided in this subparagraph. Such total increase shall include the increases described in subdivisions (i), (ii), (iii), and (iv) of this subparagraph, and shall be added to, and assessed and collected as a part of, the tax under subtitle A for the taxable year of the recovery. Proper adjustment of such increases shall be made on account of the application of the provisions of this subparagraph to intervening taxable years. Proper adjustment shall also be made in the determination of such increases in the case of a taxpayer who has made a valid election under section 1020, relating to the adjustment of basis of property for depreciation, obsolescence, amortization, and depletion. The term "tax previously determined" as used in this subparagraph shall have the same meaning as used in section 1314 (a) and shall include any tax under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. In computing the amount of the increase in the tax previously determined under chapter 1 or chapter 2 of the Internal Revenue Code of 1939 for any taxable year, the principles of section 1314 (a) shall be applicable. See section 1314 (a) and the regulations thereunder. However, the computation of the excess profits credit under chapter 2E of the Internal Revenue Code of 1939 for any taxable year shall not be affected by the adjustment provided in this subparagraph. All credits allowable against the tax for any year shall be taken into account in computing the increase in the tax previously determined. The increases referred to above include the following:

(i) The increase, if any, in the tax previously determined for each prior taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year. After the tax previously determined has been ascertained, such tax shall be recomputed by disregarding such allowable deduction (to the extent that it does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and any other deductions allowable on account of other war losses or any other losses, expenditures or accruals in such prior taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127 (c) (3) or section 22 (b) (12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the

tax previously determined for the taxable year.

(ii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which a net operating loss deduction was allowable, if all or a part of such deduction was attributable to the carryover or carryback to such taxable year of a net operating loss from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction. In the determination of such net operating loss deduction the net operating loss shall be recomputed by disregarding the deduction allowable on account of the war loss in respect of which there is a recovery in the taxable year to which such increase is to be added (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127 (c) (3) or section 22 (b) (12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year.

(iii) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carryover or carryback to such taxable year of an unused excess profits credit from another taxable year in which a deduction was allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such unused excess profits credit carryover or carryback. In the recomputation such carryover or carryback shall be redetermined by disregarding such allowable war loss deduction (to the extent such deduction does not exceed the sum of the amount of the recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127 (c) (3) or section 22 (b) (12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The difference between the tax previously determined and the tax as recomputed will be the increase in the tax previously determined for the taxable year. In case there is an increase in the excess profits tax under chapter 2E of the Internal Revenue Code of 1939 for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 of the Internal Revenue Code of 1939 for such taxable year, the increase in the tax previously determined shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

(iv) The increase, if any, in the tax previously determined for any taxable year (including the taxable year of the recovery) in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment for such taxable year, if all or a part of such adjustment was attributable to the carryover or carryback to such taxable year of an unused excess profits credit from another taxable year in which there was allowable a net operating loss deduction attributable to the carryover or carryback to such other taxable year of a net operating loss, and such net operating loss resulted in whole or in part from the deduction allowable on account of the destruction or seizure of the property in respect of which there is a recovery in the taxable year to which such increase is to be added. After the tax previously determined has been ascertained, such tax shall be recomputed by redetermining such net operating loss deduction and such unused excess profits credit carryover or carryback. In the redetermination of such net operating loss deduction the net operating loss carryover or carryback shall be recomputed by disregarding such allowable war loss deduction (to the extent that such deduction does not exceed the sum of the amount of such recovery not included in gross income for the taxable year of such recovery, plus the aggregate amount of any recoveries in intervening taxable years in respect of the same property) and by disregarding any other deductions allowable on account of other war losses or any other losses, expenditures, or accruals in the taxable year in respect of which, and to the extent that, recoveries in intervening taxable years have been excluded from gross income under section 127 (c) (3) or section 22 (b) (12) of the Internal Revenue Code of 1939, or section 1333 or section 111 of the Internal Revenue Code of 1954, or otherwise. The unused excess profits credit carryover or carryback shall then be recomputed to conform to the redetermination of the net operating loss deduction for the taxable year from which the unused credit is carried over or carried back. The difference between the tax previously determined and the tax as recomputed shall be the amount of the increase which shall be added to the tax for the taxable year of the recovery. In case there is an increase in the excess profits tax under chapter 2E of the Internal Revenue Code of 1939 for the taxable year in which an unused excess profits credit was availed of in computing the unused excess profits credit adjustment, and a decrease in the income tax under chapter 1 of the Internal Revenue Code of 1939 for such taxable year, the increase which shall be added to the tax for the taxable year of the recovery shall be considered to be an amount equal to the excess of the increase in the excess profits tax over the decrease in the income tax.

§ 1.1334 Statutory provisions; restoration of value of investments referable to destroyed or seized property.

SEC. 1334. *Restoration of value of investments referable to destroyed or seized property.* For purposes of this part, the restoration in whole or in part of the value of any interest described in section 127 (a) (3) of the Internal Revenue Code of 1939 by reason of any recovery of money or property in respect of property to which such interest related and which was considered under subsection (a) (1) or (2) of such section 127 as destroyed or seized shall be deemed a recovery of property in respect of property considered under such section 127 (a) as destroyed or seized. In applying section 1333, such restoration shall be treated as the recovery of the same interest considered under such section 127 (a) as destroyed or seized.

§ 1.1334–1 Restoration of value of investments.

If any interest of the taxpayer in or with respect to property was determined to be worthless and was treated as a war loss under section 127(a)(3) of the Internal Revenue Code of 1939 (see 26 CFR (1939) 29.127(a)–4) (Regulations 111), or if the taxpayer retained an interest in a corporation with respect to which he sustained a war loss under section 127 (e) of the Internal Revenue Code of 1939, and if the interest in the hands of the taxpayer is restored in value, in whole or in part, by reason of a recovery with respect to the underlying assets treated as war loss property, then such restoration in value is a recovery by the taxpayer for the purposes of section 1331. In the application of section 1333, such restoration shall be treated as a recovery of the same interest considered as destroyed or seized. War loss property is considered as not being in existence from the date of the loss to the date of its recovery.

§ 1.1335 Statutory provisions; election by taxpayer for application of section 1333.

SEC. 1335. *Election by taxpayer for application of section 1333.* If the taxpayer elects to have section 1333 apply to any taxable year in which he recovered any money or property in respect of property considered under section 127 (a) of the Internal Revenue Code of 1939, as destroyed or seized, section 1333 shall apply to all taxable years of the taxpayer beginning after December 31, 1941, and such election, once made, shall be irrevocable. The election shall be made in such manner and at such time as the Secretary or his delegate may by regulations pre-

scribe, except that no election under this section may be made unless the taxpayer recovers money or property (in respect of property considered under such section 127 (a) as destroyed or seized) during the taxable year for which the election is made. If pursuant to such election section 1333 applies to any taxable year—

(1) The period of limitations provided in chapter 66 on the making of assessments and the beginning of distraint or a proceeding in court for collection shall not, with respect to—

(A) The amount to be added to the tax for such taxable year under section 1333, and

(B) Any deficiency for such taxable year or for any other taxable year, to the extent attributable to the basis of the recovered property being determined under section 1336 (b),

expire before the expiration of 2 years following the date of the making of such election, and such amount and such deficiency may be assessed at any time before the expiration of such period notwithstanding any law or rule of law which would otherwise prevent such assessment and collection, and

(2) In case refund or credit of any overpayment resulting from the application of section 1333 to such taxable year is prevented on the date of the making of such election, or within one year from such date, by the operation of any law or rule of law (other than section 7122, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within one year from such date.

In the case of any taxable year ending before the date of the making by the taxpayer of an election under this section, no interest shall be paid on any overpayment resulting from the application of section 1333 to such taxable year, and no interest shall be assessed or collected with respect to any amount or any deficiency specified in paragraph (1) for any period before the expiration of 6 months following the date of the making of such election by the taxpayer.

§ 1.1335–1 Elective method; time and manner of making election and effect thereof.

(a) *In general.* If the taxpayer elects to have the provisions of section 1333 applicable to any taxable year in which any money or property is recovered in respect of war loss property, section 1333 will be applicable by virtue of that election to all taxable years of the taxpayer beginning after December 31, 1941. Thus, the taxpayer need not make an election with respect to each separate taxable year in which he had a recovery. An election for any taxable year in which the taxpayer had a recovery in respect of a prior war loss is sufficient to make the provisions of section 1333 applicable not only to war loss recoveries received by the taxpayer in any past taxable year beginning after December 31, 1941, but to any recoveries which may be received by the taxpayer in any future taxable year. Such election once made shall be irrevocable. The election to have the provisions of section 1333 applicable to any taxable year cannot be made unless the taxpayer recovers money or property (in respect of a prior war loss) during the taxable year for which such election is made.

(b) *Manner of election.* In all cases the election to have the provisions of section 1333 apply must be made by the taxpayer not later than six months from the last day prescribed by law for the filing of his income tax return for any taxable year in which a recovery of war loss property has occurred. The election shall be evidenced by a written statement, made within such 6-month period, that the taxpayer elects to have the provisions of section 1333 apply to any taxable year in which any money or property is recovered in respect of war loss property. The statement may be made in (or attached to)—

(1) The return or amended return filed for such taxable year;

(2) A claim for refund or credit filed for such taxable year for an overpayment resulting from application of such provisions;

(3) A timely petition or amended petition to The Tax Court of the United States for a redetermination of any deficiency for any taxable year in which a recovery of war loss property occurred; or

(4) A letter addressed to the district director for the district in which the return for such taxable year was required to be filed.

If the written statement of election is made in a letter, it shall be signed by the taxpayer making the election if an individual or, if the taxpayer is not an individual, the letter must be executed in the same manner as required in the case of the income tax return of such taxpayer. The date of the making of the election shall be the date the return, amended return, claim for refund or credit, or letter is filed in the office of the district director, or the date the petition or amended petition is filed with The Tax Court of the United States. In case the election is made in a return filed before the last day prescribed by law for the filing thereof (including any extension of time for such filing), such election shall not be considered made until such last day. See section 7502 and the regulations thereunder with respect to the timeliness of filing an election where filing is done by mail and section 7503 and the regulations thereunder with respect to the timeliness of filing where the last day for filing falls on a Saturday, Sunday, or legal holiday.

(c) *Effect of election.* (1) If the provisions of section 1333 are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with the provisions of paragraph (a) of this section, the period of limitations provided in chapter 66 of the Code on the making of assessments and the beginning of distraint or a proceeding in court for collection with respect to (i) the amount to be added to the tax for such taxable year under the provisions of section 1333 and (ii) any deficiency for such taxable year or for any other taxable year to the extent attributable to the basis of the recovered property being determined under the provisions of section 1336 (b), shall not expire prior to the expiration of two years following the date of the making of such election. Such amount or such deficiency may be assessed at any time prior to the expiration of such period, notwithstanding any law or rule of law which would otherwise prevent such assessment and collection.

(2) If the provisions of section 1333 are applicable to any taxable year pursuant to an election made by the taxpayer in accordance with the provisions of paragraph (a) of this section, and refund or credit of any overpayment resulting from the application of such provisions to such taxable year is prevented on the date of the making of such election, or within one year from such date, by the operation of any law or rule of law (other than section 7122 relating to compromises), refund or credit of such overpayment may nevertheless be made or allowed, provided claim therefor is filed within one year from such date. Thus, the amount of such overpayment which may be refunded or credited is not subject to the limitations contained in section 6511 or 6512 (b).

(3) In the case of any taxable year ending before the date of the making by the taxpayer of an election under section 1335, no interest shall be paid on any overpayment specified in subparagraph (2) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer, and no interest shall be assessed or collected with respect to any amount or any deficiency specified in subparagraph (1) of this paragraph for any period before the expiration of six months following the date of the making of such election by the taxpayer.

§ 1.1336 Statutory provisions; basis of recovered property.

SEC. 1336. *Basis of recovered property*—(a) *In general.* The unadjusted basis of property recovered in respect of property considered as destroyed or seized under section 127 (a) of the Internal Revenue Code of 1939 shall be determined under this section. Such basis shall be an amount equal to the fair market value of such property, determined as of the date of the recovery, reduced by an amount equal to the excess of the aggregate of such fair market value and the amounts of previous recoveries of money or property in respect of property considered under such section 127 (a) as destroyed or seized over the aggregate of the allowable deductions in prior taxable years on account of the destruction or seizure of property described in such section 127 (a), and increased by that portion of the amount of the recovery which under section 1332 is treated as a recognized gain from the involuntary conversion of property. On application of the taxpayer, the aggregate of the bases (determined under the preceding sentence) of any properties recovered in respect of properties considered under such section 127 (a) as destroyed or seized may be allocated among the properties so recovered in such manner as the Secretary or his delegate may determine under regulations prescribed by the Secretary or his delegate, and the amounts so allocated to any such property so recovered shall be the unadjusted basis of such property in lieu of the unadjusted basis of such property determined under the preceding sentence.

(b) *Property recovered in taxable year to which section 1333 applies.* In the case of a taxpayer who has made an election under section 1335, the basis of property recovered shall be an amount equal to the value at which such property is included in the amount of the recovery under section 1333 (1) (determined without regard to the last sentence thereof), reduced by such part of the gain under section 1333 (3) which is not recognized as provided in section 1033.

§ 1.1336–1 Basis of recovered property.

(a) *General rule.* (1) Under section 1336 (a), the unadjusted basis of any war loss property which is recovered and the unadjusted basis of any property which is recovered in lieu of or on account of any such war loss property is considered the fair market value of such recovered property upon the date of its recovery with the following adjustments:

(i) If the sum of the recoveries for the day such property is recovered and of all previous recoveries exceeds the aggregate of the allowable deductions for prior taxable years on account of war losses, so that a portion of the recoveries for such day is treated as gain on the involuntary conversion of property, such fair market value of the property is reduced by the total gain, if any, for such day derived from such recovered property as determined under paragraph (b) of § 1.1332–1.

(ii) Such fair market value, as reduced under subdivision (i) of this subparagraph, is increased by the portion, if any, of the recognized gain resulting from the recoveries for such day which is allocable to such recovered property, as determined under paragraph (b) of § 1.1332–1.

In effect, the unadjusted basis of such property is its fair market value upon the date of its recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of paragraph (b) of § 1.1332–1.

(2) If the respective bases of several properties of a taxpayer determined under section 1336 (a) are greatly disproportionate to their adjusted bases immediately before their treatment as war loss properties, the taxpayer may apply to the Commissioner for the allocation of the aggregate of the bases of such properties among them in the proportion of their adjusted bases immediately before the destruction or seizure of such properties determined under section 127 (a) of the Internal Revenue Code of 1939. The amount so allocated to any such property, in an application approved by the Commissioner, shall be the unadjusted basis of such property in lieu of the amount determined under subparagraph (1) of this paragraph.

(3) The application to the Commissioner shall set forth a list of all the properties of the taxpayer having an unadjusted basis determined under this section, a description of each such property together with a statement as to the amount of its adjusted basis immediately before the destruction or seizure of such property determined under section 127 (a) of the Internal Revenue Code of 1939, and a statement as to whether there has been any substantial change in the use or nature of the property chosen for the allocation from its nature or use immediately before the time it was treated as destroyed or seized. Such application will be allowed unless there has been such a substantial change in the nature or use of such property that the allocation of the bases would produce an arbitrary result, or unless the taxpayer has obtained such tax benefits by reason of the basis determined under subparagraph (1) of this paragraph, that it would be inequitable to change his basis. Thus, the allocation will not be allowed if it would give the taxpayer an unadjusted basis with respect to any property which is less than the amount of the adjustments in reduction of the basis of such property which are allowable after its recovery. For example, when property A is recovered it has an unadjusted basis of $100. After $70 depreciation has been allowed on A, an allocation is sought which would give A an unadjusted basis of $60. Since this is less than the depreciation which is an adjustment against such basis, the allocation will not be permitted.

(4) The amount of any adjustments to the unadjusted basis determined under subparagraph (1) of this paragraph shall, upon the allocation of the bases, be taken as an adjustment to the allocated unadjusted basis. Thus, if $30 depreciation was allowed upon a $100 basis determined under subparagraph (1) of this paragraph and if the unadjusted basis upon allocation is $75, such $30 depreciation is allowed against such allocated unadjusted basis, so that the adjusted basis of the property is then $45.

(5) The taxpayer may choose any group of recovered properties for allocation, except that if any such recovered properties form one economic unit, such properties may not be separated but all or none must be included in the group. For example, a building may not be separated from the land on which it stands if both are recovered property, nor may one block of stock in a corporation be separated from other stock in such corporation or from bonds in such corporation which are also treated as a recovery. If the taxpayer has once been permitted to allocate the bases of any group of properties, he may obtain another allocation with respect to such properties only if all the properties in the original group are included together with other recovered properties not included in the original group. For example, if the bases of properties A and B are allocated, a second allocation will be made for properties A, B, and C, but not for A and C or B and C.

(b) *Property recovered in taxable year to which section 1333 is applicable.* If, pursuant to an election made by the taxpayer under section 1335 and paragraph (a) of § 1.1335–1, the provisions of section 1333 are applicable to any taxable year in which the taxpayer recovered property in respect of a war loss under section 127 (a) of the Internal Revenue Code of 1939, the unadjusted basis of such property shall be the fair market value of such property determined as of the date of the recovery, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of paragraph (b) of § 1.1333–1. However, if the property recovered is the same war loss property, and if the taxpayer under section 1333 (1) includes such property in the amount of the recovery at its adjusted basis (for determining loss) in his hands on the date such property was considered under section 127 (a) of the Internal Revenue Code of 1939 as destroyed or seized, the unadjusted basis of such property shall be such adjusted basis, reduced by the amount of nonrecognized gain attributable to such recovery under the provisions of paragraph (b) of § 1.1333–1. The fair market value of any property recovered, or the adjusted basis for determining loss) of such property if the same property treated as war loss property is recovered, shall not be reduced in determining the unadjusted basis of such property by the amount of the obligations or liabilities with respect to such property in respect of which the recovery was received, if the taxpayer for any previous taxable year chose under section 127 (b) (2) of the Internal Revenue Code of 1939 to treat such obligations or liabilities as discharged or satisfied out of such property but such obligations or liabilities were not so discharged or satisfied prior to the date of the recovery.

§ 1.1337 Statutory provisions; applicable rules.

SEC. 1337. *Applicable rules*—(a) *Determination of tax benefits.* The determination as to whether and to what extent an allowable deduction on account of the destruction or seizure of property described in section 127 (a) of the Internal Revenue Code of 1939 did or did not result in a reduction of any tax of the taxpayer under chapter 1 or 2 of such code shall be made in accordance with regulations prescribed by the Secretary or his delegate.

(b) *Partial worthlessness of certain investments treated as war losses under 1939 Code.* The part of the stock or other interest of the taxpayer treated under subsection (e) of such section 127 as property described in subsection (a) (3) of such section shall be treated in the same manner for purposes of this part.

§ 1.1337–1 Determination of tax benefits from allowable deductions.

(a) That part of the aggregate of the deductions allowed a taxpayer for any taxable year on account of war losses under section 127(a) of the Internal Revenue Code of 1939 which, if disallowed, would not result in an increase in the normal tax, surtax (including the tax imposed by section 102 of the Internal Revenue Code of 1939), or victory tax of taxpayer, or of any tax imposed in lieu of such taxes or of any tax imposed by chapter 2 of the Internal Revenue Code of 1939, for the taxable year in which such deductions are allowed or in any other taxable year, such as a taxable year in which the taxpayer's income tax is computed by reference to a carryover or carryback of net operating losses from the taxable year in which such deductions are allowed, is considered, for the purposes of section 127(a) of the Internal Revenue Code of 1939 an allowable deduction for the taxable year which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code of 1939. In the case of recoveries of war losses and other items to which the recovery exclusion provisions of section 111 apply, such as bad debts, the determination of the tax benefit should be made in accordance with section 111(b) and the regulations thereunder. The deductions allowed a taxpayer for any taxable year on

account of war losses are all the deductions on account of war losses which were claimed by the taxpayer in a return, in a claim for credit or refund of an overpayment, or in a petition to The Tax Court of the United States with respect to such taxable year and which were not disallowed, and all deductions on account of war losses which, although not so claimed by the taxpayer, were nevertheless allowed (for example, by the Commissioner, a court, or The Tax Court) in computing a tax of the taxpayer.

(b) Any deduction allowable for a taxable year on account of a war loss under section 127 (a) of the Internal Revenue Code of 1939 which was not claimed by the taxpayer for such year in a return, a claim for credit or refund of an overpayment, or a petition to the Tax Court of the United States and was not allowed as a deduction (for example, by the Commissioner, a court, or the Tax Court) in computing his tax for such year or for any other year is considered a deduction which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code of 1939, since it is an allowable deduction which was not allowed in computing any tax of the taxpayer. If the taxpayer claimed for any taxable year a deduction on account of a war loss, and if such deduction was disallowed, the taxpayer may not subsequently contend for the purposes of section 1331 that such deduction was an allowable deduction for such taxable year.

(c) If the taxpayer elected under section 127 (b) of the Internal Revenue Code of 1939 to decrease the amount of a war loss by treating the obligations and liabilities described in that section as discharged or satisfied out of the property destroyed or seized, and if the taxpayer establishes that any of the obligations and liabilities were not so discharged or satisfied, then the amount by which such continuing obligations and liabilities decreased the war loss shall be considered an allowable deduction for the taxable year in which the war loss was sustained which did not result in a reduction of any tax of the taxpayer under chapter 1 or chapter 2 of the Internal Revenue Code of 1939.

CLAIM OF RIGHT

§ 1.1341 Statutory provisions; computation of tax where taxpayer restores substantial amount held under claim of right.

SEC. 1341. *Computation of tax where taxpayer restores substantial amount held under claim of right*—(a) *General rule.* If—

(1) An item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) A deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) The amount of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) The tax for the taxable year computed with such deduction; or

(5) An amount equal to—

(A) The tax for the taxable year computed without such deduction, minus

(B) The decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

For purposes of paragraph (5) (B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income).

(b) *Special rules.* (1) If the decrease in tax ascertained under subsection (a) (5) (B) exceeds the tax imposed by this chapter for the taxable year (computed without the deduction) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

(2) Subsection (a) does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. This paragraph shall not apply if the deduction arises out of refunds or repayments made by a regulated public utility (as defined in section 1503 (c) without regard to paragraph (2) thereof) if such refunds or repayments are required to be made by the government, political subdivision, agency, or instrumentality referred to in such section.

§ 1.1341–1 Restoration of amounts received or accrued under claim of right.

(a) *In general.* (1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

(2) For the purpose of this section "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and "restoration to another" means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

(3) For purposes of determining whether the amount of a deduction described in section 1341 (a) (2) exceeds $3,000 for the taxable year, there shall be taken into account the aggregate of all such deductions with respect to each item of income (described in section 1341 (a) (1)) of the same class.

(b) *Determination of tax.* (1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341 (a) (4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341 (a) (5), that is, without taking such deduction into account, minus the decrease in tax (under chapter 1 of the Internal Revenue Code of 1954 or under chapter 1 (other than subchapter E) of the Internal Revenue Code of 1939 or under the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. For the purpose of this subdivision, the amount of the decrease in tax is not limited to the amount of the tax for the taxable year. See paragraph (i) of this section where the decrease in tax for the prior taxable year (or years) exceeds the tax for the taxable year.

(2) If the taxpayer computes his tax for the taxable year under the provisions of section 1341 (a) (5) and subparagraph (1) (ii) of this paragraph, the amount of the restoration shall not be taken into account in computing taxable income or loss for the taxable year, including the computation of any net operating loss carryback or carryover or any capital loss carryover.

(3) If the tax determined under subparagraph (1) (i) of this paragraph is the same as the tax determined under subparagraph (1) (ii) of this paragraph, the tax imposed for the taxable year under chapter 1 shall be the tax determined under subparagraph (1) (i) of this paragraph, and section 1341 and this section shall not otherwise apply.

(c) *Application to deductions which are capital in nature.* Section 1341 and this section shall also apply to a deduction which is capital in nature otherwise allowable in the taxable year. If the deduction otherwise allowable is capital in nature, the determination of whether the taxpayer is entitled to the benefits of section 1341 and this section shall be made without regard to the net capital loss limitation imposed by section 1211. For example, if a taxpayer restores $4,000 in the taxable year and such amount is a long-term capital loss, the taxpayer will, nevertheless, be considered to have met the $3,000 deduction requirement for purposes of applying this section, although the full amount of the loss might not be allowable as a deduction for the taxable year. However, if the tax for the taxable year is computed with the deduction taken into account, the deduction allowable will be subject to the limitation on capital losses provided in section 1211, and the capital loss carryover provided in section 1212.

(d) *Determination of decrease in tax for prior taxable years*—(1) *Prior taxable years.* The prior taxable year (or years) referred to in paragraph (b) of

this section is the year (or years) in which the item to which the deduction is attributable was included in gross income under a claim of right and, in addition, any other prior taxable year (or years) the tax for which will be affected by the exclusion from gross income in such prior taxable year (or years) of such income.

(2) *Amount of exclusion from gross income in prior taxable years.* (i) The amount to be excluded from gross income for the prior taxable year (or years) in determining the decrease in tax under section 1341 (a) (5) (B) and paragraph (b) (1) (ii) of this section shall be the amount restored in the taxable year, but shall not exceed the amount included in gross income in the prior taxable year (or years) under the claim of right to which the deduction for the restoration is attributable, and shall be adjusted as provided in subdivision (ii) of this subparagraph.

(ii) If the amount included in gross income for the prior taxable year (or years) under the claim of right in question was reduced in such year (or years) by a deduction allowed under section 1202 (or section 117 (b) of the Internal Revenue Code of 1939 or corresponding provisions of prior revenue laws), then the amount determined under subdivision (i) of this subparagraph to be excluded from gross income for such year (or years) shall be reduced in the same proportion that the amount included in gross income under a claim of right was reduced.

(iii) The determination of the amount of the exclusion from gross income of the prior taxable year shall be made without regard to the capital loss limitation contained in section 1211 applicable in computing taxable income for the current taxable year. The amount of the exclusion from gross income in a prior taxable year (or years) shall not exceed the amount which would, but for the application of section 1211, be allowable as a deduction in the taxable year of restoration.

(iv) The rule provided in subdivision (iii) of this subparagraph may be illustrated as follows:

Example. For the taxable year 1952, an individual taxpayer had long-term capital gains of $50,000 and long-term capital losses of $10,000, a net long-term gain of $40,000. He also had other income of $5,000. In 1956, taxpayer restored the $50,000 of long-term gain. He had no capital gains or losses in 1956 but had other income of $5,000. If his tax liability for 1956, the taxable year of restoration, is computed by taking the deduction into account, the taxpayer would be entitled to a deduction under section 1211 of only $1,000 on account of the capital loss. However, if the taxpayer computes his tax under section 1341 (a) (5) and paragraph (b) (1) (ii) of this section, it is necessary to determine the decrease in tax for 1952. In such a determination, $50,000 is to be excluded from gross income for that year, resulting in a net capital loss for that year of $10,000, and a capital loss deduction of $1,000 under section 117 (d) of the Internal Revenue Code of 1939 (corresponding to section 1211 of the Internal Revenue Code of 1954) with carryover privileges. The difference between the tax previously determined and the tax as recomputed after such exclusion for the years affected will be the amount of the decrease.

(3) *Determination of amount of deduction attributable to prior taxable years.* (i) If the deduction otherwise allowable for the taxable year relates to income included in gross income under a claim of right in more than one prior taxable year and the amount attributable to each such prior taxable year cannot be readily identified, then the portion attributable to each such prior taxable year shall be that proportion of the deduction otherwise allowable for the taxable year which the amount of the income included under the claim of right in question for the prior taxable year bears to the total of all such income included under the claim of right for all such prior taxable years.

(ii) The rule provided in subdivision (i) of this subparagraph may be illustrated as follows:

Example. Under a claim of right, A included in his gross income over a period of three taxable years an aggregate of $9,000 for services to a certain employer, in amounts as follows: $2,000 for taxable year 1952, $4,000 for taxable year 1953, and $3,000 for taxable year 1954. In 1955 it is established that A must restore $6,750 of these amounts to his employer, and that A is entitled to a deduction of this amount in the taxable year 1955. The amount of the deduction attributable to each of the prior taxable years cannot be identified. Accordingly, the amount of the deduction attributable to each prior taxable year is:

$$1952—\$6{,}750 \times \frac{\$2{,}000}{\$9{,}000} = \$1{,}500$$

$$1953—\$6{,}750 \times \frac{\$4{,}000}{\$9{,}000} = \$3{,}000$$

$$1954—\$6{,}750 \times \frac{\$3{,}000}{\$9{,}000} = \$2{,}250$$

(4) *Computation of amount of decrease in tax.* (i) In computing the amount of decrease in tax for a prior taxable year (or years) resulting from the exclusion from gross income of the income included under a claim of right, there must first be ascertained the amount of tax previously determined for the taxpayer for such prior taxable year (or years). The tax previously determined shall be the sum of the amounts shown by the taxpayer on his return or returns, plus any amounts which have been previously assessed (or collected without assessment) as deficiencies or which appropriately should be assessed or collected, reduced by the amount of any refunds or credits which have previously been made or which appropriately should be made. After the tax previously determined has been ascertained, a recomputation must then be made to determine the decrease in tax, if any, resulting from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction otherwise allowable in the taxable year is attributable.

(ii) No item other than the exclusion of the income previously included under a claim of right shall be considered in computing the amount of decrease in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax. For the purpose of determining the decrease in tax for the prior taxable year (or years) which would result from the exclusion from gross income of the item included under a claim of right, the exclusion of such item shall be given effect not only in the prior taxable year in which it was included in gross income but in all other prior taxable years affected by the inclusion of the item (for example, prior taxable years affected by a net operating loss carryback or carryover or capital loss carryover).

(iii) The rules provided in this subparagraph may be illustrated as follows:

Example (1). For the taxable year 1954, a corporation had taxable income of $35,000, on which it paid a tax of $12,700. Included in gross income for the year was $20,000 received under a claim of right as royalties. In 1957, the corporation is required to return $10,000 of the royalties. It otherwise has taxable income in 1957 of $5,000, so that without the application of section 1341 it has a net operating loss of $5,000 in that year. Facts also come to light in 1957 which entitle the corporation to an additional deduction of $5,000 for 1954. When a computation is made under paragraph (b) (1) (i) of this section, the corporation has no tax for the taxable year 1957. When a computation is made under paragraph (b) (1) (ii) of this section, the tax for 1957, without taking the restoration into account, is $1,500, based on a taxable income of $5,000. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954		$12,700
Taxable income for 1954 upon which tax shown on return was based	$35,000	
Less: Additional deduction (on account of which credit or refund could be made)	5,000	
Total	30,000	
Tax on $30,000 (adjusted taxable income for 1954)	10,100	
Tax on $30,000 (adjusted taxable income for 1954)		$10,100
Taxable income for 1954, as adjusted	$30,000	
Less exclusion of amount restored	10,000	
Taxable income for 1954 by applying paragraph (b) (1) (ii) of this section	20,000	
Tax on $20,000		6,000
Decrease in tax for 1954 by applying paragraph (b) (1) (ii) of this section		4,100
Tax for 1957 without taking the restoration into account		1,500
Amount by which decrease exceeds the tax for 1957 computed without taking restoration into account		2,600

(The $2,600 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a

refund. In addition the taxpayer has made an overpayment of $2,600 ($12,700 less $10,100) for 1954 because of the additional deduction of $5,000.)

Example (2). Assume the same facts as in example (1) except that, instead of the corporation being entitled to an additional deduction of $5,000 for 1954, it is determined that the corporation failed to include an item of $5,000 in gross income for that year. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954		$12,700
Taxable income for 1954 upon which tax shown on return was based	$35,000	
Plus: Additional income (on account of which deficiency assessment could be made)	5,000	
Total	40,000	
Tax on $40,000 (adjusted taxable income for 1954)		15,300
Tax on $40,000 (adjusted taxable income for 1954)		$15,000
Taxable income for 1954 as adjusted	$40,000	
Less exclusion of amount restored	10,000	
Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section	30,000	
Tax on $30,000		10,100
Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section		5,200
Tax for 1957 without taking the restoration into account		1,500
Amount by which decrease exceeds the tax for 1957 computed without taking the restoration into account		3,700

(The $3,700 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1957 and is available as a refund. In addition the taxpayer has a deficiency of $2,600 ($15,300 less $12,700) for 1954 because of the additional income of $5,000.)

Example (3). For the taxable year 1954, a corporation had taxable income of $25,000, on which it paid a tax of $7,500. Included in gross income for the year was $10,000 received under a claim of right as commissions. In 1956, the corporation is required to return $5,000 of the commissions. The corporation has a net operating loss of $10,000 for 1956, excluding the deduction for the $5,000 restored. When a computation is made under either paragraph (b)(1)(i) or paragraph (b)(1)(ii) of this section, the corporation has no tax for the taxable year 1956. The decrease in tax for 1954 is computed as follows:

Tax shown on return for 1954		$7,500
Taxable income for 1954 upon which tax shown on return was based	$25,000	
Less: Additional deduction (on account of net operating loss carryback from 1956)	10,000	
Net income as adjusted	15,000	
Tax on $15,000 (adjusted taxable income for 1954)		4,500
Tax on $15,000 (adjusted taxable income for 1954)		$4,000
Taxable income for 1954, as adjusted	$15,000	
Less: exclusion of amount restored	5,000	
Taxable income for 1954 by applying paragraph (b)(1)(ii) of this section	10,000	
Tax on $10,000		3,000
Decrease in tax for 1954 by applying paragraph (b)(1)(ii) of this section		1,500
Tax for 1956 without taking the restoration into account		None
Amount by which decrease exceeds the tax for 1956 computed without taking the restoration into account		1,500

(The $1,500 is treated as having been paid on the last day prescribed by law for the payment of the tax for 1956 and is available as a refund. In addition, the taxpayer has an overpayment of $3,000 ($7,500 less $4,500) for 1954 because of the net operating loss deduction of $10,000.)

Example (4). For the taxable year 1946 a married man with no dependents, who kept his books on the cash receipts and disbursements basis, filed a return (claiming two exemptions) disclosing adjusted gross income of $42,000, deductions amounting to $12,000, and a net income of $30,000. Gross income included among other items salary in the amount of $15,000 and rental income in the amount of $5,000. During the taxable year he donated $10,000 to the American Red Cross and in his return claimed a deduction of $6,300 on account thereof, representing the maximum deduction allowable under the 15-percent limitation imposed by section 23 (o) of the Internal Revenue Code of 1939 for the year 1946. In computing his net income he omitted interest income amounting to $6,000 and neglected to take a deduction for interest paid in the amount of $4,500. The return disclosed a tax liability of $11,970, which was assessed and paid. In 1955, after the expiration of the period of limitations upon the assessment of a deficiency or the allowance of a refund for 1946, the taxpayer had to restore the $5,000 included in his gross income in 1946 as rental income. The amount of the decrease in tax for 1946 is $2,467.62, computed as follows:

Tax previously determined for 1946		$11,970.00
Net income for 1946 upon which tax previously determined was based	30,000.00	
Less: Rents included under claim of right	5,000.00	
Balance	25,000.00	
Adjustment for contributions (add 15 percent of $5,000)	750.00	
Net income as adjusted	25,750.00	
Tax on $25,750		9,502.38
Amount of decrease in tax for 1946:		
Tax previously determined	11,970.00	
Tax as recomputed	9,502.38	
Decrease in tax		2,467.62

The recomputation to determine the amount of the decrease in tax for 1946 does not take into consideration the barred item of $6,000 representing interest received, which was omitted from gross income, or the barred item of $4,500 representing interest paid for which no deduction was allowed. See subdivision (ii) of this subparagraph.

(e) *Method of accounting.* The provisions of section 1341 and this section shall be applicable in the case of a taxpayer on the cash receipts and disbursements method of accounting only to the taxable year in which the item of income included in a prior year (or years) under a claim of right is actually repaid. However, in the case of a taxpayer on the cash receipts and disbursements method of accounting who constructively received an item of income under a claim of right and included such item of income in gross income in a prior year (or years), the provisions of section 1341 and this section shall be applicable to the taxable year in which the taxpayer is required to relinquish his right to receive such item of income. Such provisions shall be applicable in the case of other taxpayers only to the taxable year which is the proper taxable year (under the method of accounting used by the taxpayer in computing taxable income) for taking into account the deduction resulting from the restoration of the item of income included in a prior year (or years) under a claim of right. For example, if the taxpayer is on an accrual method of accounting, the provisions of this section shall apply to the year in which the obligation properly accrues for the repayment of the item included under a claim of right.

(f) *Inventory items, stock in trade, and property held primarily for sale in the ordinary course of trade or business.* (1) Except for amounts specified in subparagraph (2) of this paragraph the provisions of section 1341 and this section do not apply to deductions attributable to items which were included in gross income by reason of the sale or other disposition of stock in trade of the taxpayer (or other property of a kind which would properly have been included in the inventory of the taxpayer if on hand at the close of the prior taxable year) or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. This section is, therefore, not applicable to sales returns and allowances and similar items.

(2) The provisions of section 1341 and this section apply to deductions which arise out of refunds or repayments made by a regulated public utility, as defined in section 1503(c) (1) or (3) and paragraph (g) of § 1502–2, if such refunds or repayments are required to be made by the government, political subdivision, agency, or instrumentality referred to in such section. Thus, deductions attributable to refunds of charges for the sale of natural gas under rates approved temporarily by a proper governmental authority are eligible for the benefits of section 1341 and this section, if such refunds are required by the governmental authority.

(g) *Bad debts.* The provisions of sections 1341 and this section do not apply to deductions attributable to bad debts.

(h) *Legal fees and other expenses.* Section 1341 and this section do not apply to legal fees or other expenses incurred by a taxpayer in contesting the restoration of an item previously included in income. This rule may be illustrated by the following example:

Example. A sold his personal residence to B in a prior taxable year and realized a capital gain on the sale. C claimed that under an agreement with A he was entitled to a 5-percent share of the purchase price since he brought the parties together and was instrumental in closing the sale. A

rejected C's demand and included the entire amount of the capital gain in gross income for the year of sale. C instituted action and in the taxable year judgment is rendered against A who pays C the amount involved. In addition, A pays legal fees in the taxable year which were incurred in the defense of the action. Section 1341 applies to the payment of the 5-percent share of the purchase price to C. However, the payment of the legal fees, whether or not otherwise deductible, does not constitute an item restored for purposes of section 1341 (a) and paragraph (a) of this section.

(i) *Refunds.* If the decrease in tax for the prior taxable year (or years) determined under section 1341(a)(5)(B) and paragraph (b)(1)(ii) of this section exceeds the tax imposed by chapter 1 of the Code for the taxable year computed without the deduction, the excess shall be considered to be a payment of tax for the taxable year of the deduction. Such payment is deemed to have been made on the last day prescribed by law for the payment of tax for the taxable year and shall be refunded or credited in the same manner as if it were an overpayment of tax for such taxable year.

§ 1.1342 Statutory provisions; computation of tax where taxpayer recovers substantial amount held by another under claim of right.

SEC. 1342. *Computation of tax where taxpayer recovers substantial amount held by another under claim of right*—(a) *General rule.* If—

(1) An item was deducted from gross income for a prior taxable year (or years) because it appeared that another person held an unrestricted right to such item as a result of a court decision in a patent infringement suit (whether or not the taxpayer is a party to such suit); and

(2) Gross income is increased for the taxable year because it was established after the close of such prior taxable year (or years) that such other person did not have an unrestricted right to such item or to a portion of such item because of the subsequent reversal of such court decision on the ground that such decision was induced by fraud or undue influence; and

(3) The amount of such increase in gross income exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) The tax for the taxable year computed with the gross income so increased; or

(5) An amount equal to—

(A) The tax for the taxable year computed without such increase in gross income, plus

(B) The increase in tax (including interest) under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the elimination of such item (or portion thereof) as a deduction from gross income for such prior taxable year (or years).

(b) *Special rule.* For purposes of subsection (a)(5)(B) interest shall be computed from the due date of the return for such prior taxable year to the due date of the return for the taxable year.

[Sec. 1342 as added by sec. 3, Act of Aug. 12, 1955 (Pub. Law 384, 84th Cong., 69 Stat. 717)]

§ 1.1342–1 Computation of tax where taxpayer recovers substantial amount held by another under claim of right; effective date.

Section 1342 shall apply with respect to taxable years beginning after December 31, 1954.

OTHER LIMITATIONS

§ 1.1346 Statutory provisions; recovery of unconstitutional Federal taxes.

SEC. 1346. *Recovery of unconstitutional Federal taxes.* Income (excluding interest) attributable to the recovery during the taxable year of a tax imposed by the United States which has been held unconstitutional, and in respect of which a deduction was allowed in a prior taxable year, may be excluded from gross income for the taxable year, and the deduction allowed in respect thereof in such prior taxable year treated as not having been allowable, if—

(1) The taxpayer elects in writing (at such time and in such manner as may be prescribed by regulations prescribed by the Secretary or his delegate) to treat such deduction as not having been allowable for such prior taxable year, and

(2) The taxpayer consents in writing to the assessment, within such period as may be agreed on, of any deficiency resulting from such treatment, even though the statutory period for the assessment of any such deficiency had expired before the filing of such consent.

§ 1.1346–1 Recovery of unconstitutional taxes.

(a) *In general.* (1) A taxpayer who recovers unconstitutional Federal taxes which were paid or accrued and for which a deduction was allowed in a prior taxable year may elect, as provided in paragraph (b) of this section, to exclude the income (exclusive of interest) attributable to such recovery from his gross income in the taxable year of recovery. Any such exclusion of income is subject to the requirements of section 1346 and this section.

(2) If a taxpayer elects to receive the benefits of section 1346, the income (exclusive of interest) attributable to the recovery of the unconstitutional Federal tax will be treated as an offset to the deduction allowed therefor in a prior taxable year (or years). The taxpayer's return for the prior taxable year (or years) with respect to which the statutory period for the assessment of a deficiency has expired will be opened only for the purpose of reducing the deduction allowed for the unconstitutional Federal tax and assessing the resulting deficiency or deficiencies, if any. (An election under section 1346 may be made only if the taxpayer consents in writing to such assessment. See paragraph (b) of this section.) No other adjustment will be allowed.

(3) If the disallowance of the deduction allowed in respect of a prior taxable year results in a deficiency for that year, the deficiency will be assessed against the taxpayer within the period agreed upon between the taxpayer and the district director with respect to the taxable year of the prior deduction, even though the statutory period for the assessment may have expired prior to the filing of the consent.

(4) If a taxpayer does not elect under the provisions of section 1346 and this section to exclude the tax recovered from gross income in the taxable year of recovery, the tax recovered shall, from the standpoint of its inclusion in or exclusion from gross income, be governed by the provisions of section 111.

(b) *Manner of making election.* (1) The election provided for in paragraph (a) of this section shall be made by the taxpayer filing a statement in writing that he elects to treat the deduction allowed in a prior taxable year for the unconstitutional tax as not having been allowable for such taxable year. Such a statement must be filed with the taxpayer's return for the taxable year in which the recovery of the unconstitutional tax or taxes occurs. No other method of making the election is permitted. The statement of election must contain a description of the tax recovered, the date of recovery, the taxable year in which paid or accrued, and the taxable year for which the deduction was allowed. The statement of election must also contain a statement signifying the taxpayer's consent (i) to treat the deduction or portion thereof allowed in a prior year with respect to the unconstitutional tax as not allowable for that year and (ii) to the assessment, in respect of the taxable year for which the deduction was allowed, of any deficiency, together with interest thereon as provided by law, resulting from disallowance of the deduction or portion thereof, even though the statutory period for the assessment of any such deficiency may have expired before the filing of such consent.

(2) The term "recovery", as used in this section, includes not only refund or credit of taxes previously paid, but also the cancellation of a purported tax liability which was accrued and deducted for a prior taxable year but never actually paid.

§ 1.1347 Statutory provisions; claims against United States involving acquisition of property.

SEC. 1347. *Claims against United States involving acquisition of property.* In the case of amounts (other than interest) received by a taxpayer from the United States with respect to a claim against the United States involving the acquisition of property and remaining unpaid for more than 15 years, the tax imposed by section 1 attributable to such receipt shall not exceed 30 percent of the amount (other than interest) so received.

§ 1.1347–1 Tax on certain amounts received from the United States.

(a) In the case of an amount (other than interest) received from the United States by an individual under a claim involving acquisition of property and remaining unpaid for more than 15 years, the tax imposed by section 1 attributable to such amount shall not exceed 30 percent of the amount (other than interest) so received. For the purpose of section 1347 and this section, such amount shall not include any amount received from the United States which constitutes interest, whether such interest was included in the claim or in any judgment thereon or has accrued on such judgment.

(b) To determine the application of section 1347 and this section to a particular amount, the taxpayer shall first compute the tax imposed by section 1 upon his entire taxable income, including the amount specified in paragraph (a) of this section, without regard to the limitation on tax provided in section

1347. The proportion of the tax, so computed, indicated by the ratio which the taxpayer's taxable income attributable to the amount specified in paragraph (a) of this section, computed as prescribed in paragraph (c) of this section, bears to his total taxable income, is the portion of the tax attributable to such amount. If this portion of the tax exceeds 30 percent of the amount specified in paragraph (a) of this section, that portion of the tax shall be reduced to 30 percent of such amount.

(c) In determining the portion of the taxable income attributable to any amount specified in paragraph (a) of this section, the taxpayer shall allocate to such amount received and to the gross income derived from all other sources, the expenses, losses, and other deductions properly attributable thereto, and shall apply any general expenses, losses, and other deductions (which cannot be properly apportioned otherwise) ratably to the gross income from all sources. The amount specified in paragraph (a) of this section, less the deductions properly attributable thereto and less its proportion of any general deductions, shall be the taxable income attributable to such amount. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

ELECTION OF CERTAIN PARTNERSHIPS AND PROPRIETORSHIPS AS TO TAXABLE STATUS

§ 1.1361 [Reserved]

ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO TAXABLE STATUS

§ 1.1371 Statutory provisions; definitions.

SEC. 1371. *Definitions*—(a) *Small business corporation.* For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not—

(1) Have more than 10 shareholders;

(2) Have as a shareholder a person (other than an estate) who is not an individual;

(3) Have a nonresident alien as a shareholder; and

(4) Have more than one class of stock.

(b) *Electing small business corporation.* For purposes of this subchapter, the term "electing small business corporation" means, with respect to any taxable year, a small business corporation which has made an election under section 1372(a) which, under section 1372, is in effect for such taxable year.

(c) *Stock owned by husband and wife.* For purposes of subsection (a)(1) stock which—

(1) Is community property of a husband and wife (or the income from which is community income) under the applicable community property law of a State, or

(2) Is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,

shall be treated as owned by one shareholder.

[Sec. 1371 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1650); amended by sec. 2(a), Act of Sept. 23, 1959 (Pub. Law 86-376, 73 Stat. 699)]

§ 1.1371-1 Definition of small business corporation.

(a) *In general.* For purposes of subchapter S, chapter 1 of the Code and §§ 1.1371 through 1.1377-3, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group of corporations (as defined in section 1504) and which does not have—

(1) More than 10 shareholders,

(2) As a shareholder a person (other than an estate) who is not an individual,

(3) A nonresident alien as a shareholder, and

(4) More than one class of stock.

(b) *Domestic corporation.* The term "domestic corporation," as used in section 1371(a), means a corporation as defined in section 7701(a)(3) created or organized in the United States or under the law of the United States or of any State or Territory. The term does not include an unincorporated business enterprise electing to be taxed as a domestic corporation under section 1361.

(c) *Member of an affiliated group.* A corporation which is a member of an affiliated group of corporations, as defined in section 1504, is not a small business corporation, whether or not such affiliated group has ever filed a consolidated return. However, for any period prior to September 24, 1959, see section 1504(b)(8), under which an electing small business corporation is excluded from the definition of "includible corporation."

(d) *Number of shareholders*—(1) *In general.* A corporation does not qualify as a small business corporation if it has more than 10 shareholders. Ordinarily, the persons who would have to include in gross income dividends distributed with respect to the stock of the corporation are considered to be the shareholders of the corporation. For example, if stock is owned by tenants in common, joint tenants, or tenants by the entirety, each tenant in common, joint tenant, or tenant by the entirety is generally considered a shareholder, but see subparagraph (2) of this paragraph relating to stock owned by husband and wife. Persons for whom a stock in a corporation is held by a nominee, agent, guardian, or custodian will generally be considered shareholders of the corporation. If stock is owned by a trust which is subject to the provisions of subchapters D, F, H, or J, chapter 1 of the Code, or by a voting trust, the trust is considered the shareholder even though the dividends paid to the trust are includible directly in the income of the grantor or some other person. If stock is owned by a partnership, such partnership and not its partners is considered to be the shareholder.

(2) *Stock owned by husband and wife.* (i) Except as otherwise provided under subdivision (ii) of this subparagraph, in determining whether a corporation meets the 10 or fewer shareholders requirement of section 1371(a), stock which—

(*a*) Is community property of a husband and wife (or the income from which is community income) under the applicable community-property law of a State, or

(*b*) Is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,

shall be treated as owned by one shareholder. For this purpose, if a husband or wife owns stock in a corporation individually, and the husband and wife own other stock in the corporation jointly, the husband and wife will be considered one shareholder. However, if the husband and wife each owns stock in the corporation individually, they will be treated as two shareholders. This subdivision applies only in determining the number of shareholders for purposes of section 1371(a)(1) and does not apply for purposes of any other provisions of subchapter S, chapter 1 of the Code. Thus, for example, the husband and wife will each be considered a shareholder for purposes of section 1372(a), relating to the requirement that all shareholders consent to the corporation's election, and section 1373(a), relating to the inclusion in the shareholder's gross income of the corporation's undistributed taxable income.

(ii) Subdivision (i) of this subparagraph does not apply in determining the number of shareholders for any taxable year of the corporation which begins before January 1, 1960. Thus, if stock is owned as community property (or if the income from the stock is community income), or if stock is owned by a husband and wife as tenants in common, joint tenants, or tenants by the entirety, then, for any taxable year of the corporation which begins before January 1, 1960, both the husband and wife having a community interest in such stock (or the income therefrom) and each tenant in common, joint tenant, or tenant by the entirety is generally considered a shareholder.

(e) *Shareholders must be individuals or estates.* A corporation in which any shareholder is a corporation, trust, or partnership does not qualify as a small business corporation. The word "trust" as used in this paragraph includes all trusts subject to the provisions of subchapter D, F, H, or J (including subpart E thereof), chapter 1 of the Code and voting trusts. Thus, even though the grantor is treated as the owner of all or any part of a trust, the corporation in which such trust is a shareholder does not meet the qualifications of a small business corporation.

(f) *No nonresident alien shareholder.* A corporation having a nonresident alien shareholder does not qualify as a small business corporation.

(g) *Classes of stock.* A corporation having more than one class of stock does not qualify as a small business corporation. In determining whether a corporation has more than one class of stock, only stock which is issued and outstanding is considered. Therefore, treasury stock and unissued stock of a different class than that held by the shareholders will not disqualify a corporation under section 1371(a)(4). If the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. Thus, a difference as to voting rights, dividend rights, or liquidation prefer-

ences of outstanding stock will disqualify a corporation. However, if two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock. If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock.

§ 1.1371–2 Definition of electing small business corporation.

Section 1371(b) defines an electing small business corporation in terms of a particular taxable year. If a small business corporation, as defined in section 1371(a), has made an election under section 1372(a), and such election is in effect for the taxable year in question, then the corporation is an electing small business corporation for such taxable year. A corporation is not an electing small business corporation as to a particular taxable year if it was ineligible to make the election or if a termination under section 1372(e) is effective as to such taxable year.

§ 1.1372 Statutory provisions; election by small business corporation.

SEC. 1372. *Election by small business corporation*—(a) *Eligibility.* Except as provided in subsection (f), any small business corporation may elect, in accordance with the provisions of this section, not to be subject to the taxes imposed by this chapter. Such election shall be valid only if all persons who are shareholders in such corporation—

(1) On the first day of the first taxable year for which such election is effective, if such election is made on or before such first day, or

(2) On the day on which the election is made, if the election is made after such first day,

consent to such election.

(b) *Effect.* If a small business corporation makes an election under subsection (a), then—

(1) With respect to the taxable years of the corporation for which such election is in effect, such corporation shall not be subject to the taxes imposed by this chapter and, with respect to such taxable years and all succeeding taxable years, the provisions of section 1377 shall apply to such corporation, and

(2) With respect to the taxable years of a shareholder of such corporation in which or with which the taxable years of the corporation for which such election is in effect end, the provisions of sections 1373, 1374, and 1375 shall apply to such shareholder, and with respect to such taxable years and all succeeding taxable years, the provisions of section 1376 shall apply to such shareholder.

(c) *Where and how made*—(1) *In general.* An election under subsection (a) may be made by a small business corporation for any taxable year at any time during the first month of such taxable year, or at any time during the month preceding such first month. Such election shall be made in such manner as the Secretary or his delegate shall prescribe by regulations.

(2) *Taxable years beginning before date of enactment.* An election may be made under subsection (a) by a small business corporation for its first taxable year which begins after December 31, 1957, and on or before the date of the enactment of this subchapter, and ends after such date at any time—

(A) Within the 90-day period beginning on the day after the date of the enactment of this subchapter, or

(B) If its taxable year ends within such 90-day period, before the close of such taxable year.

An election may be made pursuant to this paragraph only if the small business corporation has been a small business corporation (as defined in section 1371(a)) on each day after the date of the enactment of this subchapter and before the day of such election.

(d) *Years for which effective.* An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, unless it is terminated, with respect to any such taxable year, under subsection (e).

(e) *Termination*—(1) *New shareholders.* An election under subsection (a) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation—

(A) On the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

(B) On the day on which the election is made, if such election is made after such first day,

becomes a shareholder in such corporation and does not consent to such election within such time as the Secretary or his delegate shall prescribe by regulations. Such termination shall be effective for the taxable year of the corporation in which such person becomes a shareholder in the corporation and for all succeeding taxable years of the corporation.

(2) *Revocation.* An election under subsection (a) made by a small business corporation may be revoked by it for any taxable year of the corporation after the first taxable year for which the election is effective. An election may be revoked only if all persons who are shareholders in the corporation on the day on which the revocation is made consent to the revocation. A revocation under this paragraph shall be effective—

(A) For the taxable year in which made, if made before the close of the first month of such taxable year,

(B) For the taxable year following the taxable year in which made, if made after the close of such first month,

and for all succeeding taxable years of the corporation. Such revocation shall be made in such manner as the Secretary or his delegate shall prescribe by regulations.

(3) *Ceases to be small business corporation.* An election under subsection (a) made by a small business corporation shall terminate if at any time—

(A) After the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

(B) After the day on which the election is made, if such election is made after such first day,

the corporation ceases to be a small business corporation (as defined in section 1371(a)). Such termination shall be effective for the taxable year of the corporation in which the corporation ceases to be a small business corporation and for all succeeding taxable years of the corporation.

(4) *Foreign income.* An election under subsection (a) made by a small business corporation shall terminate if for any taxable year of the corporation for which the election is in effect, such corporation derives more than 80 percent of its gross receipts from sources outside the United States. Such termination shall be effective for the taxable year of the corporation in which it derives more than 80 percent of its gross receipts from sources outside the United States, and for all succeeding taxable years of the corporation.

(5) *Personal holding company income.* An election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

(f) *Election after termination.* If a small business corporation has made an election under subsection (a) and if such election has been terminated or revoked under subsection (e), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year prior to its fifth taxable year which begins after the first taxable year for which such termination or revocation is effective, unless the Secretary or his delegate consents to such election.

[Sec. 1372 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1650)]

§ 1.1372–1 Election by small business corporation.

(a) *Eligibility.* Under section 1372, an eligible small business corporation may elect not to be subject to the taxes imposed by chapter 1 of the Code. The qualifications of a small business corporation must be met as of the first day of the first taxable year of the corporation for which the election is to be effective and on the date of election, unless the election is made after such first day, in which case the qualifications need not exist prior to the date of election. For example, the existence of a corporate shareholder or a nonresident alien as a shareholder prior to the date of election does not preclude qualification. However, if the election is made for a taxable year beginning before September 3, 1958, the qualifications must be met on such date and on each day after such date and before the date of election. The election by a small business corporation is valid only if all the shareholders in the corporation on the first day of the first taxable year for which the election is to be effective, or on the date of election, whichever is later, consent to such election. See § 1.1372–3, relating to shareholders' consent.

(b) *Effect of election*—(1) *Effect on corporation.* The effect on a small business corporation of a valid election under section 1372 is to exempt such corporation from the taxes imposed by chapter 1 of the Code with respect to taxable years of the corporation for which the election is in effect and to subject the corporation with respect to such taxable years and all its subsequent taxable years to section 1377, relating to special rules for computing the earnings and profits of an electing small business corporation.

(2) *Effect on shareholders.* The effect of a valid election by the corporation is to subject the shareholders to the provisions of section 1373 (providing for the taxation of the corporation's undistributed taxable income to the shareholders), section 1374 (allowing the net operating

loss of the electing corporation to the shareholders), section 1375 (relating to special rules applicable to distributions of an electing small business corporation), and section 1376 (relating to adjustment to basis of stock of, and indebtedness owing, shareholders). The provisions of sections 1373, 1374, and 1375 apply only to a taxable year of the shareholder affected by the election. Section 1376 applies to such taxable year and all succeeding taxable years of the shareholder. A person who ceased to be a shareholder during the first month of the corporation's taxable year in which a valid election is made, but prior to the date of election, is subject to the provisions of sections 1374, 1375, and 1376 even though such person is not an individual or an estate.

(c) *Other chapter 1 rules applicable.* To the extent that other provisions of chapter 1 of the Code are not inconsistent with those under subchapter S of such chapter and the regulations thereunder, such provisions will apply with respect to both the electing small business corporation and its shareholders in the same manner that they would apply had no election been made. For example:

(1) In general, except as otherwise provided in section 1373(d), taxable income of an electing small business corporation is computed in the same manner that it would have been had no election been made;

(2) Section 301, relating to distributions of property, applies to distributions by an electing small business corporation in the same manner that it would apply had no election been made;

(3) Sections 302, 303, 304, and 331 are applicable in determining whether distributions by an electing small business corporation are to be treated as in exchange for stock;

(4) Section 305 applies to distributions by an electing small business corporation of its own stock;

(5) Section 311 applies to distributions by an electing small business corporation;

(6) Except as provided in sections 1375(d)(1) and 1377, earnings and profits of an electing small business corporation are computed in the same manner that they would have been computed had no election been made;

(7) Section 316, relating to the definition of a dividend, applies to distributions by an electing small business corporation except as provided in section 1375(d)(1), relating to distributions of previously taxed income (see paragraphs (d) and (e) of § 1.1373–1 for rules relating to allocation of current earnings and profits to distributions during the taxable year); and

(8) Section 341, relating to collapsible corporations, may apply to gain on the sale or exchange of, or a distribution which is in exchange for, stock in an electing small business corporation.

§ 1.1372–2 Manner and time for making election and filing shareholders' consent.

(a) *Manner of making election.* The election of a small business corporation should be made by the corporation by filing Form 2553, containing the information required by such form, and by filing, in the manner provided in § 1.1372–3, a statement of the consent of each shareholder of the corporation. The election form shall be signed by any person who is authorized to sign the return required under section 6037 and shall be filed with the district director with whom such return is to be filed.

(b) *Time of making election*—(1) *Taxable years beginning on or after September 3, 1958.* For taxable years beginning on or after September 3, 1958, the election shall be filed either (i) during the first month of such taxable year, or (ii) during the month preceding such first month. In the case of a new corporation whose taxable year begins after the first day of a particular month, the term "month" means the period commencing with the beginning of the first day of the taxable year and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no such corresponding day, with the close of the last day of such succeeding calendar month. For purposes of this subparagraph, the first month of the taxable year of a new corporation does not begin until the corporation has shareholders or acquires assets or begins doing business, whichever is the first to occur.

(2) *Taxable years beginning on or before September 2, 1958.* For taxable years beginning on or before September 2, 1958, but after December 31, 1957, and ending after September 2, 1958, the election shall be made on or before December 1, 1958, or on or before the last day of the corporation's taxable year, whichever is earlier. An election for such taxable year may be made, however, only if the corporation has been a small business corporation on each day after September 2, 1958, and before the date of election.

(3) *Election prior to expiration of period.* An election under section 1372(a) which is made prior to the expiration of the period for making the election is binding and may not be withdrawn even though the time within which the election could have been made has not elapsed.

(c) *Years for which election is effective.* An election under section 1372 may be made only with respect to taxable years beginning after December 31, 1957, and ending after September 2, 1958. An election is effective for the entire taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, unless it is terminated with respect to any taxable year. Thus, the election has a continuing effect and need not be renewed annually, although annual returns of information must be filed under section 6037.

§ 1.1372–3 Shareholders' consent.

(a) *In general.* The consent of a shareholder to an election by a small business corporation shall be in the form of a statement signed by the shareholder in which such shareholder consents to the election of the corporation. Such shareholder's consent is binding and may not be withdrawn after a valid election is made by the corporation. The consent of a minor shall be made by the minor or by his legal guardian, or his natural guardian if no legal guardian has been appointed. The consent of an estate shall be made by the executor or administrator thereof. The statement shall set forth the name and address of the corporation and of the shareholder, the number of shares of stock owned by him, and the date (or dates) on which such stock was acquired. The consents of all shareholders may be incorporated in one statement. The consents of all persons who are shareholders at the time the election is made shall be attached to the election of the corporation. If the election is made before the first day of the corporation's taxable year for which it is effective, the consents of persons who become shareholders after the date of election and are shareholders on such first day shall be filed with the district director with whom the election was filed as soon as practicable after such first day. Where a consent is filed after the date of election, a copy of the consent shall also be filed with the return required to be filed under section 6037. A consent will be considered timely if it is filed on or before the last day prescribed for making the election. In the case of a shareholder in a community-property State whose spouse has filed a timely consent, the consent of such shareholder will also be considered timely if it is filed on or before February 2, 1959, or the last day prescribed for making the election, whichever is later. An election under section 1372 will not be valid if any of the consents are not timely filed. However, an election which was timely filed for any taxable year beginning before March 1, 1960, and which would be valid but for the fact that the consent of any shareholder of the corporation was not filed or was defective in any manner, will not be invalid if—

(1) A proper consent is filed by such shareholder after December 19, 1959, and on or before March 1, 1960,

(2) All shareholders of the corporation who previously filed timely and proper consents file new consents within the period mentioned in subparagraph (1) of this paragraph, and

(3) The shareholders show to the satisfaction of the district director with whom the election under section 1372 was filed that the failure to file timely and proper consents was not due to an intention to avoid making a valid election.

(b) *New shareholders.* If a person becomes a shareholder of an electing small business corporation after the first day of the taxable year for which the election is effective, or after the day on which the election is made (if such day is later than the first day of the taxable year), the consent of such shareholder shall be made in a statement filed (with the district director with whom the election is filed) within the period of 30 days beginning with the day on which such person becomes a new shareholder. A

copy of such consent should be furnished to the corporation by the new shareholder. If the new shareholder is an estate, the 30-day period shall not begin until the executor or administrator has qualified under local law to perform his duties, but in no event shall such period begin later than 30 days following the close of the corporation's taxable year in which the estate became a shareholder. The statement of consent shall set forth the name and address of the corporation and of such new shareholder, the number of shares of stock owned by such shareholder, the date on which such shares were acquired, and the name and address of each person from whom such shares were acquired. A copy of the consent of such new shareholder shall be filed with the return required to be filed under section 6037 for the taxable year to which such consent applies. For the effect of the failure of a new shareholder to consent, see paragraph (b)(1) of § 1.1372–4.

§ 1.1372–4 Termination of election.

(a) *In general.* An election under section 1372(a) can be terminated in any one of the five ways described in section 1372(e) (1) through (5) and paragraph (b) of this section. For years affected by termination, see paragraph (c) of this section.

(b) *Methods of termination*—(1) *Failure of new shareholder to consent.* An election under section 1372(a) shall terminate if any person who was not a shareholder on the first day of the first taxable year for which the election is effective, or on the day on which the election is made (if such day is later than the first day of the taxable year), becomes a shareholder and does not consent to the election under section 1372(a) within the time prescribed by paragraph (b) of § 1.1372–3. However, an election which would not have terminated except for the failure of any new shareholder to file a timely consent or except for the fact that the consent of any such new shareholder was defective in any manner is not terminated if—

(i) A proper consent is filed by all such new shareholders after December 19, 1959, and on or before March 1, 1960,

(ii) All persons who previously filed timely and proper consents, and who were shareholders of the corporation at any time during the taxable year in which the termination would have occurred, file new consents within the period mentioned in subdivision (i) of this subparagraph, and

(iii) The shareholders show to the satisfaction of the district director with whom the election under section 1372 was filed that the failure of the new shareholders to file timely and proper consents was not due to an intention to terminate the election.

In the event of a termination caused by the failure of a new shareholder to consent to the election within the required time, the corporation shall notify the district director with whom the election under section 1372(a) was filed.

(2) *Revocation.* An election under section 1372(a) may be revoked by the corporation for any taxable year of the corporation after the first taxable year for which the election is effective. A revocation can be made only with the consent of all the persons who are shareholders at the beginning of the day of revocation. Such revocation shall be made by the corporation by filing a statement that the corporation revokes the election made under section 1372(a), which statement shall indicate the first taxable year of the corporation for which the revocation is intended to be effective. The statement shall be signed by any person authorized to sign the return of the corporation under section 6037 and shall be filed with the district director with whom the election was filed. In addition, there shall be attached to the statement of revocation a statement of consent, signed by each person who is a shareholder of the corporation at the beginning of the day on which such statement of revocation is filed, in which each such shareholder consents to the revocation by the corporation of the election under section 1372(a). For the time within which a revocation must be made to be effective for a particular taxable year of the corporation, see paragraph (c) of this section.

(3) *Ceases to be small business corporation.* An election under section 1372(a) terminates if at any time after the first day of the first taxable year of the corporation for which the election is effective, or after the day on which the election is made (if such day is later than the first day of the taxable year), the corporation ceases to be a small business corporation as defined in section 1371(a). Thus, the election is terminated if an eleventh person, a nonresident alien, or a trust, partnership, or corporation becomes a shareholder, or if another class of stock is issued by the corporation. In the event of a termination under this subparagraph the corporation shall immediately notify the district director with whom the election under section 1372(a) was filed. Such notification shall set forth the cause of the termination and the date thereof. In addition, if the termination was caused by the transfer of stock to an eleventh shareholder, to a nonresident alien, or to a trust, partnership, or corporation, the notification shall specify the number of shares transferred to such person, the name of such person (or in the case of a trust the names of the trustees and beneficiaries), and the name of the shareholder who transferred such stock to such person. If the termination was caused by the issuance of a second class of stock, the notification shall indicate the number of shares of such new class issued and shall describe the differentiating characteristics of the new class of stock.

(4) *Foreign income.* (i) An election terminates if for any taxable year of the corporation the corporation has gross receipts, more than 80 percent of which are derived from sources outside the United States. For the meaning of the term "gross receipts," see subparagraph (5)(ii) of this paragraph. In determining the source of gross receipts under section 1372(e)(4), the principles of part I (section 861 and following), subchapter N, chapter 1 of the Code, relating to determination of sources of gross income, shall apply.

(ii) The rules of this subparagraph may be illustrated by the following example:

Example. A corporation has gross receipts from the sale of personal property produced (in whole or in part) by the corporation within the United States and sold within a foreign country. An independent factory or production price has not been established as provided in example (1) of paragraph (b)(2) of § 1.863–3. One-half of the gross receipts from the sale of such property shall be apportioned in accordance with the value of the corporation's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the corporation's property within the United States, and the denominator of which consists of the value of the corporation's property both within the United States and within the foreign country. The remaining one-half of such gross receipts shall be apportioned in accordance with the gross sales of the corporation within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the corporation's gross sales for the taxable year within the United States, and the denominator of which consists of the corporation's gross sales for the taxable year both within the United States and within the foreign country.

(5) *Personal holding company income*—(i) *In general.* An election shall terminate if for any taxable year of the corporation the corporation has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities, as determined in accordance with the rules of this subparagraph.

(ii) *Gross receipts.* (a) The term "gross receipts" as used in section 1372(e) is not synonymous with "gross income". The test under section 1372(e)(4) and (5) shall be made on the basis of total gross receipts, except that, for purposes of section 1372(e)(5), gross receipts from the sales or exchanges of stock or securities shall be taken into account only to the extent of gains therefrom. The term "gross receipts" means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Thus, the total amount of receipts is not reduced by returns and allowances, cost, or deductions. For example, gross receipts will include the total amount received or accrued during the corporation's taxable year from the sale or exchange (including a sale or exchange to which section 337 applies) of any kind of property, from investments, and for services rendered by the corporation. However, gross receipts does not include amounts received in nontaxable sales or exchanges (other than those to which section 337 applies), except to the extent that gain is recognized by the corporation, nor does that term include amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.

(b) The meaning of the term "gross receipts" as used in section 1372(e) (4) and (5) may be further illustrated by the following examples:

Example (1). A corporation on the accrual method sells property (other than stock or securities) and receives payment partly in money and partly in the form of a note payable at a future time. The amount of the money and the face amount of the note would be considered gross receipts in the taxable year of the sale and would not be reduced by the adjusted basis of the property, the costs of sale, or any other amount.

Example (2). A corporation has a long-term contract as defined in paragraph (a) of § 1.451–3 with respect to which it reports income according to the percentage-of-completion method as described in paragraph (b) (1) of § 1.451–3. The portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year shall be included in gross receipts for such year.

Example (3). A corporation which regularly sells personal property on the installment plan elects to report its taxable income from the sale of property (other than stock or securities) on the installment method in accordance with section 453. The installment payments actually received in a given taxable year of the corporation shall be included in gross receipts for such year.

(iii) *Royalties.* The term "royalties" as used in section 1372(e) (5) means all royalties, including mineral, oil, and gas royalties (whether or not the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year), and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property. The term "royalties" does not include amounts received upon disposal of timber or coal with a retained economic interest with respect to which the special rules of section 631 (b) and (c) apply or amounts received from the transfer of patent rights to which section 1235 applies. For the definition of "mineral, oil, or gas royalties", see paragraph (b) (11) (ii) and (iii) of § 1.543–1. For purposes of this subdivision, the gross amount of royalties shall not be reduced by any part of the cost of the rights under which they are received or by any amount allowable as a deduction in computing taxable income.

(iv) *Rents.* The term "rents" as used in section 1372(e) (5) means amounts received for the use of, or right to use, property (whether real or personal) of the corporation, whether or not such amounts constitute 50 percent or more of the gross income of the corporation for the taxable year. The term "rents" does not include payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant, such as for the use or ocupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist homes, motor courts, or motels. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., are generally "rents" under section 1372(e) (5). Payments for the parking of automobiles ordinarily do not constitute rents. Payments for the warehousing of goods or for the use of personal property do not constitute rents if significant services are rendered in connection with such payments.

(v) *Dividends.* The term "dividends" as used in section 1372(e) (5) includes dividends as defined in section 316, amounts required to be included in gross income under section 551 (relating to foreign personal holding company income taxed to United States shareholders), and consent dividends determined as provided in section 565.

(vi) *Interest.* The term "interest" as used in section 1372(e) (5) means any amounts received for the use of money (including tax-exempt interest).

(vii) *Annuities.* The term "annuities" as used in section 1372(e) (5) means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, regardless of whether only part of such amount would be includible in gross income under section 72.

(viii) *Gross receipts from the sale of stock or securities.* For purposes of section 1372(e) (5), gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. Thus, the gross receipts from the sale of a particular share of stock will be the excess of the amount realized over the adjusted basis of such share. If the adjusted basis should equal or exceed the amount realized on the sale or exchange of a certain share of stock, bond, etc., there would be no gross receipts resulting from the sale of such security. Losses on sales or exchanges of stock or securities do not offset gains on the sales or exchanges of other stock or securities for purposes of computing gross receipts from such sales or exchanges. Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities. For the meaning of the term "stock or securities", see paragraph (b) (5) (i) of § 1.543–1.

(c) *Years affected by termination.* The termination of an election resulting from the occurrences described in subparagraph (1), (3), (4), or (5) of paragraph (b) of this section is effective for the taxable year of the corporation in which occur the events causing the termination and for all succeeding taxable years of the corporation. Thus, if an electing small business corporation which is on a calendar year ending December 31, 1960, should issue a second class of stock on December 1, 1960, the election under section 1372(a) would terminate as of January 1, 1960, and the termination would remain in effect for all future years unless and until a new election is made by the corporation. Generally, a termination by revocation described in paragraph (b) (2) of this section is effective for the taxable year in which it is made and for all subsequent taxable years if it is made during the first month of that year. However, a termination by revocation cannot be made effective for the first taxable year of the corporation for which the election is made. If the revocation is not made during the first month of a taxable year, it is effective for the taxable year following the year in which it is made, and for all subsequent years.

§ 1.1372–5 Election after termination.

(a) *In general.* If a corporation has made a valid election and such election has been terminated, such corporation (or any successor corporation) is not eligible to make a new election for any taxable year prior to its fifth taxable year which begins after the first taxable year for which such termination is effective, unless consent to such new election is given by the Commissioner. The burden will be on the corporation to establish that under the relevant facts the Commissioner should consent to a new election. The fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation during the first taxable year for which the termination is applicable will tend to establish that consent should be granted. In the absence of such fact, consent will ordinarily be denied unless it can be shown that the event causing the termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation, and was not part of a plan to terminate the election in which plan such shareholders participated.

(b) *Successor corporation.* The term "successor corporation" as used in section 1372(f) means any corporation—

(1) 50 percent or more of the stock of which is owned, directly or indirectly, by the same persons who, at any time during the first taxable year for which such termination was effective, owned 50 percent or more of the stock of the small business corporation with respect to which the election was terminated, and

(2) (i) Which acquires a substantial portion of the assets of such small business corporation, or

(ii) A substantial portion of the assets of which were assets of such small business corporation.

§ 1.1373 Statutory provisions; corporation undistributed taxable income taxed to shareholders.

SEC. 1373. *Corporation undistributed taxable income taxed to shareholders*—(a) *General rule.* The undistributed taxable income of an electing small business corporation for any taxable year shall be included in the gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

(b) *Amount included in gross income.* Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year. For purposes of this chapter, the amount so included shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation.

(c) *Undistributed taxable income defined.* For purposes of this section, the term "undistributed taxable income" means taxable income (computed as provided in subsection (d)) minus the amount of money distributed as dividends during the taxable year, to the extent that any such amount is a distribution out of earnings and profits of the taxable year as specified in section 316(a)(2).

(d) *Taxable income.* For purposes of this subchapter, the taxable income of an electing small business corporation shall be determined without regard to—

(1) The deduction allowed by section 172 (relating to net operating loss deduction), and

(2) The deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures).

[Sec. 1373 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1652)]

§ 1.1373–1 Corporation undistributed taxable income taxed to shareholders.

(a) *In general*—(1) *Inclusion in gross income.* Each person who is a shareholder of an electing small business corporation on the last day of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend if on such last day the corporation distributed pro rata to its shareholders an amount of money equal to its undistributed taxable income for the corporation's taxable year. The amount so included in the gross income of the shareholders is treated, for purposes of chapter 1 of the Code, as if it had been distributed as a dividend on the last day of the corporation's taxable year. See, however, section 1375 for special rules applicable to distributions.

(2) *Shareholders affected by rule of section 1373.* Only those persons who are shareholders of the corporation on the last day of the taxable year of the corporation are required to include in their gross income the amounts specified in section 1373. In determining who are the shareholders of the corporation on the last day of the taxable year for purposes of section 1373, the rules of paragraph (d)(1) of § 1.1371–1 shall apply. If stock is transferred on the last day of the taxable year of the corporation, the transferee (and not the transferor) will be considered the shareholder of such stock for purposes of section 1373. A donee or purchaser of stock in the corporation is not considered a shareholder unless such stock is acquired in a bona fide transaction and the donee or purchaser is the real owner of such stock. The circumstances, not only as of the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides of the transfer. Transactions between members of a family will be closely scrutinized.

(b) *Determination of amount included by shareholders.* To determine the amount each shareholder must include in his gross income as provided in paragraph (a) of this section, it is necessary to—

(1) Compute the taxable income of the electing small business corporation for its taxable year in accordance with the provisions of paragraph (c) of this section.

(2) Determine in accordance with paragraph (d) of this section the amount of money distributed as dividends during the taxable year out of earnings and profits of such taxable year.

(3) Subtract the amount determined in subparagraph (2) of this paragraph from the amount computed in subparagraph (1) of this paragraph. The result is the undistributed taxable income for the taxable year.

(4) Determine in accordance with paragraph (e) of this section the amount that would be treated as a dividend to such shareholder if an amount of money equal to such undistributed taxable income were distributed pro rata to the shareholders of the corporation on the last day of the taxable year of the corporation in a distribution which is not in exchange for stock.

(c) *Computation of taxable income.* The taxable income of an electing small business corporation is computed in the same manner as it would be computed if no election had been made, with the following exceptions:

(1) The deduction allowed by section 172 (relating to net operating loss deductions) is disregarded, and

(2) The special corporate deductions allowed by part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code, are disregarded.

(d) *Determination of dividends in money out of earnings and profits of the taxable year.* In applying section 316(a) to distributions by an electing small business corporation, earnings and profits of the taxable year are first allocated to actual distributions of money made during such taxable year which are not in exchange for stock. Therefore, such distributions of money are dividends from earnings and profits of the taxable year to the extent of such earnings and profits even though there may be distributions of property other than money during such taxable year or constructive distributions pursuant to section 1373(b) at the end of such taxable year. If such distributions of money made during the taxable year exceed the earnings and profits of such year, then that proportion of each such distribution which the total of the earnings and profits of the year bears to the total of such distributions made during the year shall be regarded as out of the earnings and profits of that year. For purposes of section 1373(c) a distribution of money does not include a distribution of an obligation of the corporation or a distribution of property other than money in satisfaction of a dividend declared in money. See section 1377(b) for special rule relating to computation of earnings and profits of an electing small business corporation for any taxable year.

(e) *Dividend resulting from constructive distribution of undistributed taxable income.* The amount which would be treated as a dividend if the undistributed taxable income were distributed on the last day of the taxable year is determined in accordance with section 316. In determining the extent to which distributions of an electing small business corporation are out of earnings and profits of the taxable year, the following rules apply:

(1) Earnings and profits of the taxable year are first allocated to the actual distributions of money described in paragraph (d) of this section,

(2) The excess of such earnings and profits over such actual distributions of money is allocated ratably to the constructive distribution of undistributed taxable income and actual distributions of property other than money (taken into account at fair market value for purposes of this allocation) which are not in exchange for stock, and

(3) The remainder of such earnings and profits is available to be allocated to distributions in exchange for stock of the corporation such as distributions under section 302 or 331.

(f) *When distributions are considered made.* An actual distribution by an electing small business corporation will be considered to be made only at the time it is received by the shareholder, and earnings and profits of such corporation shall not be reduced with respect to such distribution before such time.

(g) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). An electing small business corporation has taxable income and current earnings and profits of $100,000 for its taxable year. During that year it distributes $80,000 in money among its 10 equal shareholders. The $8,000 received by each shareholder in that year is included in his gross income (for his taxable year in which it was received) as a dividend from current earnings and profits. The undistributed taxable income of the corporation for the taxable year is $20,000 ($100,000 minus $80,000 dividends in money). Since each shareholder would have received a dividend of $2,000 if the undistributed taxable income had been distributed pro rata, that amount must be included as a dividend in the gross income of each shareholder for his taxable year in which or with which the taxable year of the corporation ends.

Example (2). Assume the same facts as in example (1), except that the corporation has only $70,000 of taxable income. The difference between taxable income and current earnings and profits of $100,000 is attributable to the fact that certain deductions allowable in computing taxable income (such as percentage depletion in excess of cost depletion) do not decrease earnings and profits. The distributions of $80,000 during the taxable year are still included as dividends in the gross income of the shareholders since they are distributions out of earnings and profits. However, there is no amount

to be included under section 1373(b) since the corporation has no undistributed taxable income for the taxable year.

Example (3). An electing small business corporation has taxable income and earnings and profits of $10,000 for its taxable year. The corporation has no accumulated earnings and profits as of the beginning of the taxable year. During the taxable year it distributes property other than money with a basis of $10,000 and a fair market value of $20,000. The undistributed taxable income of the corporation is $10,000 since the property distribution does not reduce taxable income for purposes of that computation. However, the current earnings and profits are allocated ratably to the constructive distribution of undistributed taxable income and the distribution of property, taken into account at fair market value; that is, $3,333 to the constructive distribution and $6,667 to the distribution of property. Therefore, although undistributed taxable income is $10,000, only $3,333 would be treated as a dividend on a distribution of undistributed taxable income, and that is the amount the shareholders include pro rata in gross income pursuant to section 1373(b). The distribution of property is a dividend only to the extent of $6,667.

Example (4). Assume the facts are the same as in example (3), except that the corporation has accumulated earnings and profits of $20,000 as of the beginning of the taxable year. The $20,000 accumulated earnings and profits at the beginning of the taxable year are sufficient to cover that portion of the distribution of property which is not out of current earnings and profits ($13,333) and that portion of the constructive distribution which is not out of current earnings and profits ($6,667). Therefore, both distributions of property (at its fair market value) and the corporation's undistributed taxable income will be fully taxable as dividends.

Example (5). An electing small business corporation has taxable income and current earnings and profits of $100,000 for the taxable year. There are no accumulated earnings and profits as of the beginning of the taxable year. During the taxable year the corporation distributes $50,000 in a redemption that qualifies under section 302(a). The undistributed taxable income of the corporation is $100,000. Since the current earnings and profits of $100,000 are first allocated to the constructive distribution of $100,000, that amount is includible in the gross income of the persons who were shareholders on the last day of the corporation's taxable year.

Example (6). Corporation X of which A and B are each 50-percent shareholders has been an electing small business corporation for several years. Shortly before its taxable year 1962, corporation X adopts a plan of complete liquidation. During 1962 it has $3,000 of taxable income and current earnings and profits. The only distributions made during 1962 are distributions in liquidation. The final distribution is made on October 15, 1962, after which corporation X retains no assets and is no longer in existence for tax purposes. Corporation X has $3,000 of undistributed taxable income for its taxable year ended October 15, 1962, and A and B must each include $1,500 for his taxable year in which ends the taxable year of corporation X. Under section 1376(a), A and B both increase the basis of their respective shares in corporation X by $1,500, and this increase is taken into account in determining gain or loss on the liquidation of corporation X.

§ 1.1374 Statutory provisions; corporation net operating loss allowed to shareholders.

SEC. 1374. *Corporation net operating loss allowed to shareholders*—(a) *General rule.* A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

(b) *Allowance of deduction.* Each person who is a shareholder of an electing small business corporation at any time during a taxable year of the corporation in which it has a net operating loss shall be allowed as a deduction from gross income, for his taxable year in which or with which the taxable year of the corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), an amount equal to his portion of the corporation's net operating loss (as determined under subsection (c)).

(c) *Determination of shareholder's portion*—(1) *In general.* For purposes of this section, a shareholder's portion of the net operating loss of an electing small business corporation is his pro rata share of the corporation's net operating loss (computed as provided in section 172(c), except that the deductions provided in part VIII (except section 248) of subchapter B shall not be allowed) for his taxable year in which or with which the taxable year of the corporation ends. For purposes of this paragraph, a shareholder's pro rata share of the corporation's net operating loss is the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year. For purposes of the preceding sentence, the corporation's daily net operating loss is the corporation's net operating loss divided by the number of days in the taxable year.

(2) *Limitation.* A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of—

(A) The adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and

(B) The adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the shareholder was a shareholder in the corporation).

(d) *Application with other provisions*—(1) *In general.* The deduction allowed by subsection (b) shall, for purposes of this chapter, be considered as a deduction attributable to a trade or business carried on by the shareholder.

(2) *Adjustment of net operating loss carrybacks and carryovers of shareholders.* For purposes of determining, under section 172, the net operating loss carrybacks to taxable years beginning before January 1, 1958, from a taxable year of the shareholder for which he is allowed a deduction under subsection (b), such deduction shall be disregarded in determining the net operating loss for such taxable year. In the case of a net operating loss for a taxable year in which a shareholder is allowed a deduction under subsection (b), the determination of the portion of such loss which may be carried to subsequent years shall be made without regard to the preceding sentence and in accordance with section 172(b)(2), but the sum of the taxable incomes for taxable years beginning before January 1, 1958, shall be deemed not to exceed the amount of the net operating loss determined with the application of the preceding sentence.

[Sec. 1374 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1653); amended by sec. 2(b), Act of Sept. 23, 1959 (Pub. Law 86-376, 73 Stat. 699)]

§ 1.1374-1 Net operating losses involving electing small business corporations.

(a) *Deduction not allowed to corporation.* Under section 1373(d), an electing small business corporation is not allowed a deduction for a net operating loss. Under section 172(h), a net operating loss sustained in taxable years in which a corporation is an electing small business corporation is disregarded in computing the net operating loss deduction of the corporation for taxable years in which it is not an electing small business corporation. In applying section 172(b)(1) and (2) to a net operating loss sustained in a taxable year in which the corporation was not an electing small business corporation, a taxable year in which the corporation was an electing small business corporation is counted as a taxable year to which such net operating loss is carried back or over. However, the taxable income for such year as determined under section 172(b)(2) is treated as if it were zero for purposes of computing the balance of the loss available to the corporation as a carryback or carryover to other taxable years in which the corporation is not an electing small business corporation.

(b) *Deduction allowed to shareholders*—(1) *In general.* Under section 1374(a), the net operating loss of an electing small business corporation is allowed as a deduction from gross income of the shareholders of such corporation. Each person who is a shareholder in such corporation at any time during a taxable year of the corporation in which a net operating loss is sustained by the corporation is entitled to a deduction for his pro rata share of such loss. The net operating loss of an electing small business corporation for any taxable year is computed as provided in section 172(c), except that the deductions provided in part VIII (section 241 and following except section 248), subchapter B, chapter 1 of the Code, are not allowed.

(2) *Year of shareholder in which deduction is allowable.* The deduction allowed shareholders by section 1374(b) is a deduction for the taxable year of the shareholder in which or with which the taxable year of the corporation ends or, in the case of shareholders who die after September 23, 1959, for the final taxable year of a shareholder who dies before the end of the corporation's taxable year.

(3) *Pro rata share.* A shareholder's pro rata share of the net operating loss of an electing small business corporation is computed as follows:

(i) Divide the corporation's net operating loss by the number of days in the taxable year of the corporation, thus determining the daily net operating loss of the corporation.

(ii) Determine for each day the shareholder's portion of such daily net operating loss by applying to such loss the ratio which the stock owned by the

shareholder on that day bears to the total stock outstanding on that day.

(iii) Total the shareholder's daily portions of such daily net operating loss of the corporation for its taxable year.

For purposes of the rule in this subparagraph, shares of stock which are transferred during the year are considered to be held by the transferee (and not the transferor) as of the day of the transfer.

(4) *Limitation on deduction*—(i) *In general.* Under section 1374(c)(2), the amount of the net operating loss of the electing small business corporation for any taxable year which may be deducted by any shareholder under section 1374(c)(1) shall not exceed the sum of:

(*a*) The adjusted basis of the shareholder's stock in the electing small business corporation, and

(*b*) The adjusted basis of any indebtedness of the corporation to the shareholder.

If a shareholder's pro rata share of the corporation's net operating loss exceeds the limitation imposed by section 1374(c)(2), such excess is not allowable as a deduction for any taxable year.

(ii) *Time for determining basis of stock and indebtedness.* The adjusted basis of the stock of, or indebtedness to, the shareholder for purposes of subdivision (i) of this subparagraph is determined as of the close of the taxable year of the corporation, except that—

(*a*) The adjusted basis of stock which is sold or otherwise disposed of during the taxable year of the corporation is determined as of the close of the day before the day of such sale or other disposition, and

(*b*) If the shareholder is not a shareholder as of the close of the taxable year of the corporation, the adjusted basis of any indebtedness of the corporation to the shareholder is determined as of the close of the last day in such taxable year on which he was a shareholder.

(iii) *Computation of basis of stock and indebtedness.* In computing the adjusted basis of stock and indebtedness for purposes of determining how much of a net operating loss may be deducted by a shareholder, any decrease in basis required by section 1376(b) because of such loss shall be disregarded. However, adjustments to the basis of stock and indebtedness under section 1376 for prior years losses of the corporation are to be considered.

§ 1.1374–2 Application with other provisions.

The deduction allowed shareholders by section 1374 shall, for purposes of chapter 1 of the Code, be considered as a deduction attributable to a trade or business carried on by the shareholder. Thus, it is allowable in computing adjusted gross income, and is not subject to the limitations of section 172(d)(4) (relating to nonbusiness deductions) in computing the net operating loss of a shareholder. Also, it is a deduction of the type on which a limitation may be imposed under section 270 (relating to "hobby losses").

§ 1.1374–3 Pre-1958 taxable years.

The deduction allowed by section 1374(b) is disregarded in determining the amount of the shareholder's net operating loss for purposes of determining the net operating loss carrybacks to taxable years beginning prior to January 1, 1958. The deduction is to be given effect, however, in computing the amount of the shareholder's net operating loss for purposes of carrying the same over or back to any year other than a year beginning prior to January 1, 1958. For purposes of determining the amount of the net operating loss which may be carried to such years, the loss shall not be diminished by taxable income for years beginning before January 1, 1958, except to the extent that it was allowed to offset income of those years.

§ 1.1374–4 Examples.

The operation of section 1374 may be illustrated by the following examples:

Example (1). Corporation X, an electing small business corporation, has a net operating loss of $10,000 for its taxable year ending December 31, 1960. At all times during its taxable year 1960 the corporation had as shareholders the same 10 individuals, each of whom owned one-tenth of the stock on each day of the corporation's taxable year. As a result of the corporation's net operating loss, each of the 10 shareholders has a $1,000 deduction for his taxable year in which or with which the taxable year of the corporation ends, assuming that such amount does not exceed the limitation of section 1374(c)(2).

Example (2). Assume the same facts as in example (1), except that A, one of the shareholders of the corporation, sells his stock to B on July 2, 1960, and B holds the stock for the remainder of the year. A and B would each have a $500 deduction resulting from the corporation's net operating loss, assuming that such amount does not exceed the limitation of section 1374(c)(2). If A's taxable year ends November 30, 1960, the $500 item will be a deduction in his taxable year ending November 30, 1961. See paragraph (a) of § 1.1376–2 for rule requiring A to reduce basis of his stock in determining gain or loss on the sale to B.

Example (3). B is entitled under section 1374 to a deduction in his taxable year 1958 of $6,000 as his share of the net operating loss of an electing small business corporation. During 1958 he has a net operating loss, computed without regard to such $6,000 deduction, of $20,000. In each of his taxable years 1955, 1956, and 1957, he had taxable income of $9,000. In each of his taxable years 1959 and 1960 he had taxable income of $3,000. Under section 1374(d)(2), the net operating loss carryback from 1958 to 1955, 1956, and 1957 does not include the $6,000 deduction resulting from the loss of the small business corporation, so that there is $7,000 of taxable income remaining in the year 1957 after the carryback. For purposes of carrying the 1958 net operating loss forward to 1959 and 1960, the $6,000 amount is included in the net operating loss, and is not reduced by taxable income of years prior to 1958. Therefore, the taxable income for the taxable years 1959 and 1960 is reduced to zero by the carryover.

§ 1.1375 Statutory provisions; special rules applicable to distributions of electing small business corporations.

SEC. 1375. *Special rules applicable to distributions of electing small business corporations*—(a) *Capital gains*—(1) *Treatment in hands of shareholders.* The amount includible in the gross income of a shareholder as dividends (including amounts treated as dividends under section 1373(b)) from an electing small business corporation during any taxable year of the corporation, to the extent that such amount is a distribution of property out of earnings and profits of the taxable year as specified in section 316(a)(2), shall be treated as a long-term capital gain to the extent of the shareholder's pro rata share of the excess of the corporation's net long-term capital gain over its net short-term capital loss for such taxable year. For purposes of this paragraph, such excess shall be deemed not to exceed the corporation's taxable income (computed as provided in section 1373(d)) for the taxable year.

(2) *Determination of shareholder's pro rata share.* A shareholder's pro rata share of such excess for any taxable year shall be an amount which bears the same ratio to such excess as the amount of dividends described in paragraph (1) includible in the shareholder's gross income bears to the entire amount of dividends described in paragraph (1) includible in the gross income of all shareholders.

(b) *Dividends received credit not allowed.* The amount includible in the gross income of a shareholder as dividends from an electing small business corporation during any taxable year of the corporation (including any amount treated as a dividend under section 1373(b)) shall not be considered a dividend for purposes of section 34, section 37, or section 116 to the extent that such amount is a distribution of property out of earnings and profits of the taxable year as specified in section 316(a)(2). For purposes of this subsection, the earnings and profits of the taxable year shall be deemed not to exceed the corporation's taxable income (computed as provided in section 1373(d)) for the taxable year.

(c) *Treatment of family groups.* Any dividend received by a shareholder from an electing small business corporation (including any amount treated as a dividend under section 1373(b)) may be apportioned or allocated by the Secretary or his delegate between or among shareholders of such corporation who are members of such shareholder's family (as defined in section 704(e)(3)), if he determines that such apportionment or allocation is necessary in order to reflect the value of services rendered to the corporation by such shareholders.

(d) *Distributions of undistributed taxable income previously taxed to shareholders—(1) Distributions not considered as dividends.* An electing small business corporation may distribute, in accordance with regulations prescribed by the Secretary or his delegate, to any shareholder all or any portion of the shareholder's net share of the corporation's undistributed taxable income for taxable years prior to the taxable year in which such distribution is made. Any such distribution shall, for purposes of this chapter, be considered a distribution which is not a dividend, but the earnings and profits of the corporation shall not be reduced by reason of any such distribution.

(2) *Shareholder's net share of undistributed taxable income.* For purposes of this subsection, a shareholder's net share of the undistributed taxable income of an electing small business corporation is an amount equal to—

(A) The sum of the amounts included in the gross income of the shareholder under section 1373(b) for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), reduced by

(B) The sum of—

(i) The amounts allowable under section 1374(b) as a deduction from gross income of the shareholder for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), and

(ii) All amounts previously distributed during the taxable year and all prior taxable

years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year) to the shareholder which under paragraph (1) were considered distributions which were not dividends.

[Sec. 1375 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1654)]

§ 1.1375–1 Special rules applicable to capital gains.

(a) *In general.* The amount includible by a shareholder in gross income as dividends received from an electing small business corporation during any taxable year of such corporation shall be treated as long-term capital gain to the extent, if any, of such shareholder's pro rata share of the excess of the corporation's net long-term capital gain over its net short-term capital loss for such taxable year. For this purpose, such excess shall not exceed the taxable income (as defined in section 1373(d)) of the corporation for the taxable year. This capital gain treatment applies both to actual distributions of dividends and to amounts treated as dividends pursuant to section 1373(b); however, it applies only to the extent that a dividend is out of earnings and profits of the current taxable year of the corporation. Furthermore, this capital gain treatment applies whether or not the shareholder held any stock in the corporation at the close of the taxable year of the corporation.

(b) *Determination of pro rata share.* To compute a shareholder's pro rata share of long-term capital gain, it is necessary to determine—

(1) The excess of the corporation's net long-term capital gain over its net short-term capital loss for the taxable year;

(2) The corporation's taxable income (as defined in section 1373(d)) for the taxable year;

(3) The amount of dividends from earnings and profits of the current taxable year included in such shareholder's gross income, determined in accordance with paragraphs (d) and (e) of § 1.1373–1; and

(4) The amount of dividends from earnings and profits of the current taxable year included in the gross income of all shareholders of the corporation during such taxable year.

The pro rata share is the amount which bears the same ratio to the lesser of the amounts determined in subparagraphs (1) and (2) of this paragraph as the amount determined in subparagraph (3) of this paragraph bears to the amount determined in subparagraph (4) of this paragraph.

(c) *Allocation of capital gains to various distributions.* If distributions of dividends (including amounts treated as dividends under section 1373(b)) out of the earnings and profits of the taxable year of an electing small business corporation are made to a shareholder at different times during the corporation's taxable year, the amount treated as capital gain to the shareholder pursuant to section 1375(a) shall be allocated ratably to the various distributions of such dividends. Thus, if the taxable year of the corporation includes portions of two taxable years of the shareholder, and in both of such years of the shareholder there are distributions treated as dividends out of earnings and profits of the corporation's taxable year, part of the capital gain is allocated to the earlier taxable year of the shareholder and part to the later taxable year.

(d) *Level for determining character of gain.* Ordinarily, for purposes of determining whether gain on the sale or exchange of an asset by an electing small business corporation is capital gain, the character of the asset is determined at the corporate level. However, if an electing small business corporation is availed of by any shareholder or group of shareholders owning a substantial portion of the stock of such corporation for the purpose of selling property which in the hands of such shareholder or shareholders would not have been an asset, gain from the sale of which would be capital gain, then the gain on the sale of such property by the corporation shall not be treated as a capital gain. For this purpose, in determining the character of the asset in the hands of the shareholder, the activities of other electing small business corporations in which he is a shareholder shall be taken into consideration.

(e) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). An electing small business corporation which has three equal shareholders has net long-term capital gain in excess of net short-term capital loss of $9,000 for its taxable year 1959. In that year it has taxable income (as defined in section 1373(d)) and current earnings and profits in excess of $9,000, but makes no distributions. Of the undistributed taxable income includible in the gross income of each of the three shareholders pursuant to section 1373(b) as dividends deemed received, $3,000 is treated as long-term capital gain.

Example (2). An electing small business corporation which has four equal shareholders has taxable income (as defined in section 1373(d)) and current earnings and profits of $80,000 for the taxable year. It has an excess of $100,000 of net long-term capital gain over net short-term capital loss for the taxable year. The corporation distributes $100,000 in money during the taxable year, $25,000 to each shareholder, all of which is treated as a dividend since the corporation had a substantial amount of accumulated earnings and profits at the beginning of the taxable year. However, since the amount which will be treated as long-term capital gain in the hands of the shareholders cannot exceed the corporation's taxable income for the taxable year, and is limited to distributions out of earnings and profits of the taxable year, the amount which can be treated as a long-term capital gain by each shareholder is $20,000.

Example (3). An electing small business corporation on the calendar year has two equal shareholders on fiscal years ending June 30. For the taxable year 1959, the corporation has taxable income and current earnings and profits of $200,000 (including a long-term capital gain of $80,000). The corporation distributes cash dividends of $75,000 to each of its shareholders on March 15, 1959, and $25,000 to each on September 15, 1959. Each shareholder's pro rata share of the corporation's capital gain is $40,000 (½ of $80,000). Of this share of the capital gain, $30,000 (75,000/100,000 of $40,000) is includible by each shareholder in his taxable year ending June 30, 1959, and $10,000 thereof in his taxable year ending June 30, 1960.

Example (4). An electing small business corporation which has three equal shareholders has a net long-term capital gain in excess of net short-term capital loss of $60,000 for its taxable year 1959. The corporation has taxable income and current earnings and profits of $80,000 (including such net capital gain of $60,000). In March 1959, the corporation pays a cash dividend of $60,000 ($20,000 to each shareholder). In April 1959, one of the shareholders sells all his shares to the other shareholders in equal amounts. No further distributions are made by the corporation. With respect to the March distribution, each shareholder will be deemed to have received capital gain of $15,000 (60,000/80,000 of $20,000) and ordinary income of $5,000. At the end of the year, there will be $20,000 of undistributed taxable income ($80,000 taxable income less $60,000 cash dividend), of which $10,000 will be includible in the income of each of the two remaining shareholders. Of the $10,000 includible by each shareholder, $7,500 (60,000/80,000 of $10,000) will be deemed to be capital gain, and the remainder ($2,500) will be ordinary income.

§ 1.1375–2 Dividends received exclusion and credit not allowed.

(a) *In general.* Under section 1375(b), the amounts includible in the gross income of a shareholder as dividends from an electing small business corporation (including amounts treated as dividends under section 1373(b)) are not considered dividends for purposes of section 34 (dividends received credit), section 37 (retirement income credit), and section 116 (partial dividend exclusion) to the extent that such amounts are distributions out of the earnings and profits of the taxable year. For purposes of the preceding sentence, the earnings and profits of the taxable year are deemed not to exceed the corporation's taxable income (as defined in section 1373(d)). For rules as to the allocation of the earnings and profits of the taxable year to distributions made during the year, see paragraphs (d) and (e) of § 1.1373–1.

(b) *Examples.* The following examples illustrate the application of section 1375(b) and paragraph (a) of this section:

Example (1). An electing small business corporation has taxable income (as defined in section 1373(d)) and earnings and profits of $10,000 for the taxable year and accumulated earnings and profits of $20,000 at the beginning of the taxable year. During the taxable year, the corporation distributes a dividend of $15,000 in money. Of the amount distributed, $10,000 is not entitled to the dividends received exclusion under section 116 or the credits under section 34 or 37, since it is paid out of the earnings and profits of the corporation's taxable year. The $5,000 paid out of accumulated earnings and profits is considered a dividend for purposes of the exclusion and credits.

Example (2). Assume the same facts as in example (1), except that the taxable income for the taxable year is $9,000 and the corporation also received $1,000 of tax-exempt interest on certain governmental obligations. Of the $15,000 distributed, only $9,000 would not be considered a dividend for purposes of the dividends received exclusion under section 116 or the credits under section 34 or 37, since, for purposes of section 1375(b), the earnings and profits for the taxable year are deemed not to exceed taxable income (as defined in section 1373(d)).

§ 1.1375–3 Treatment of family groups.

(a) *In general.* Pursuant to section 1375(c), any dividend received by a shareholder from an electing small business corporation (including any amount treated as a dividend under section 1373(b)) may be apportioned or allocated by the district director between or among shareholders of such corporation who are members of such shareholder's family, if he determines that such apportionment or allocation is necessary in order to reflect the value of services rendered to the corporation by such shareholders. In determining the value of services rendered by a shareholder, consideration shall be given to all the facts and circumstances of the business, including the managerial responsibilities of the shareholder, and the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the corporation. The taxable income of the corporation shall be neither increased nor decreased because of the reallocation of dividends under section 1375(c). The amount reallocated shall be considered a dividend to the shareholder to whom it is reallocated.

(b) *Family defined.* For purposes of section 1375(c), the family of an individual shall include only his spouse, ancestors, and lineal descendants.

(c) *Example.* The provisions of section 1375(c) may be illustrated by the following example:

Example. The stock of an electing small business corporation is owned 50 percent by F and 50 percent by S, a minor son of F. For the taxable year, the corporation has $70,000 of taxable income and earnings and profits. During the year, the corporation distributes dividends (including amounts treated as dividends under section 1373(b)) of $35,000 to F and $35,000 to S. Compensation of $10,000 is paid by the corporation to F for services rendered during the year, and no compensation is paid to S, who rendered no services. Based on the relevant facts, a reasonable compensation for the services rendered by F would be $30,000. In the discretion of the district director, up to $10,000 of the $35,000 dividend received by S may, for tax purposes, be allocated to F.

(d) *Effect of waiver of dividends resulting in disproportionate distributions among members of family.* If a nonpro-rata distribution of dividends is made to members of a family group, the member of such group who receives less than his pro rata share of such distribution will be deemed to have waived his right to dividends to the extent that his distribution is less than his pro rata share, unless he can establish that the distribution was made disproportionately without his consent. In the case of such a waiver, the amount distributed to members of the family group shall be reallocated among all the members of the group in accordance with the number of shares owned by each member.

§ 1.1375–4 Distributions of previously taxed income.

(a) *In general.* Under section 1375(d)(1), a distribution by an electing small business corporation to a shareholder of all or any portion of his net share of previously taxed income is considered a distribution which is not a dividend. Such a distribution reduces the basis of the shareholder's stock in the corporation in accordance with section 301(c)(2), and, if it exceeds such basis, is subject to the provisions of section 301(c)(3). The earnings and profits of the corporation are not reduced by reason of such a distribution. If an election is terminated under section 1372(e), the corporation may not, during the first taxable year to which the termination applies or during any subsequent taxable year, distribute previously taxed income of taxable years prior to the termination as a nondividend distribution pursuant to this section.

(b) *Source of distribution.* Except as provided in paragraph (c) of this section, any actual distribution of money by an electing small business corporation to a shareholder which, but for the operation of this section, would be a dividend out of accumulated earnings and profits shall be considered a distribution of previously taxed income to the extent of the shareholder's net share of previously taxed income immediately before the distribution. Thus, a distribution of property other than money or a distribution in exchange for stock, or a constructive distribution under section 1373(b), is never a distribution of previously taxed income. Since current earnings and profits are first applied to distributions of money which are not in exchange for stock (see paragraphs (d) and (e) of § 1.1373–1), a distribution of previously taxed income may occur only if during its taxable year the corporation makes such money distributions in excess of its earnings and profits for such taxable year.

(c) *Election.* An electing small business corporation may, with the consent of all of its shareholders, elect to treat distributions which are in excess of its earnings and profits for the taxable year as distributions out of accumulated earnings and profits, if any, rather than as distributions of previously taxed income. For any taxable year for which such election is made, a statement of election shall be filed with a timely return under section 6037 for such year. Such election applies to all distributions during such year. An election applies only for the year for which it is made, but a new election may be made for any subsequent year.

(d) *Shareholder's net share of previously taxed income.* A shareholder's net share of previously taxed income as of the time of a distribution is—

(1) The sum of the amounts included in the gross income of the shareholder under section 1373(b) for all of his taxable years ending before the distribution, less

(2) The sum of—

(i) The amounts allowable under section 1374(b) as a deduction from gross income of the shareholder for all of his taxable years ending before the distribution, and

(ii) The amounts previously distributed to the shareholder during his current taxable year and all of his prior taxable years, which, under section 1375(d)(1), were not considered dividends.

In computing the sum of the amounts included in gross income under section 1373(b), only the amount included on the shareholder's income tax return for a prior taxable year (increased or decreased by any adjustment of such amount in any redetermination of the shareholder's tax liability) is taken into account, unless the shareholder is not required to file a return for such prior taxable year. The amounts allowable under section 1374(b) as a deduction means all allowable deductions whether or not claimed on the income tax return of the shareholder and whether or not resulting in any tax benefit. If a new election is made subsequent to a termination under section 1372(e) of a prior election, a shareholder's net share of previously taxed income is determined solely by reference to taxable years which are subject to the new election.

(e) *Benefits not transferable.* A shareholder's right to nondividend distributions under this section is personal and cannot in any manner be transferred to another. If a shareholder transfers part but not all of his stock in an electing small business corporation his net share of previously taxed income is not reduced by reason of the transfer and the transferee does not acquire any part of such net share. If a shareholder transfers all of his stock in an electing small business corporation, any right which he may have had to nondividend treatment upon the receipt of distributions lapses entirely unless he again becomes a shareholder in the corporation while it is subject to the same election.

(f) *Record requirement.* A record of the net share of previously taxed income of each shareholder shall be maintained by the electing small business corporation. In addition, each shareholder of such corporation shall keep a record of his own net share of previously taxed income and shall make such record available to the corporation for its informaton.

(g) *Examples.* The operation of this section may be illustrated by the following examples:

Example (1). (i) Corporation X, of which A (a calendar year taxpayer) is the sole stockholder is an electing small business corporation for its taxable years ended December 31, 1958, 1959, and 1960. For its taxable year 1958, it has a net operating loss of $10,000. For its taxable year 1959, it has undistributed taxable income of $50,000. Assuming that A included in his return the undistributed taxable income for 1959 and assuming that the 1958 net operating loss did not exceed the limitation imposed by section 1374(c)(2), A's net share of previously taxed income as of January 1, 1960, is $40,000.

(ii) Assume the additional fact that for the taxable year 1960 Corporation X has a net operating loss of $40,000, which is fully allowable to A as a deduction. This net operating loss does not affect A's share of previously taxed income for purposes of determining the nature of distributions during 1960, since such net share is reduced only by the deductions allowable for taxable years of the shareholder ending before the distribution. However, in computing his net share of previously taxed income for years subsequent to 1960, A must take the $40,000 deduction for 1960 into account.

(iii) If in 1960, at a time when his net share of previously taxed income is $40,000, A sold his stock in the corporation to B, who was not previously a shareholder, B's net share of previously taxed income as of the date of purchase would be zero. The result would be the same if, for example, B had received the stock by gift or by bequest from A.

Example (2). Corporation Y, an electing small business corporation, is on a fiscal year ending January 31. C, a shareholder in the corporation, is on a calendar year. For its fiscal year ending January 31, 1960, corporation Y has $50,000 of undistributed taxable income, half of which is included in C's gross income for his taxable year 1960. The amount so included does not increase C's net share of previously taxed income for purposes of distributions at any time during 1960, since his net share of previously taxed income is increased only by amounts included in gross income for his taxable years ending before the distribution.

Example (3). Corporation Z, an electing small business corporation, has two equal shareholders, A and B (both calendar year taxpayers), during its taxable year ended December 31, 1960. No election is made under paragraph (c) of this section. As of the beginning of 1960, the corporation has $20,000 of accumulated earnings and profits. For the taxable year 1960, corporation Z has current earnings and profits and taxable income of $8,000. In June 1960, it makes money distributions of $5,000 to A and $5,000 to B, and in November 1960, it distributes the same amount in money to each. Immediately before the distribution in June, A's net share of previously taxed income was $6,000 and B's net share was $4,000. Current earnings and profits are allocated ratably to each of the four distributions. (See paragraphs (d) and (e) of § 1.1373–1.) Therefore, each distribution to A and B is a dividend from current earnings and profits to the extent of $2,000. As to the June distribution, the $3,000 distributed to A and B which is not out of current earnings and profits is a distribution of previously taxed income and therefore not a dividend, since immediately before the distribution the net share of each is in excess of $3,000. As to the November distribution, the $3,000 distributed to A which is not out of current earnings and profits is a nondividend distribution since his net share of previously taxed income at that date is $3,000 ($6,000 less $3,000 absorbed by the June distribution); however, the $3,000 distribution to B which is not out of current earnings and profits is a nondividend distribution to the extent of $1,000 and a dividend from accumulated earnings and profits to the extent of $2,000, since his net share of previously taxed income at that date is $1,000 ($4,000 less $3,000 absorbed by the June distribution).

Example (4). Corporation N, an electing small business corporation, has current earnings and profits and taxable income of $30,000 for 1960. As of the beginning of that taxable year, it has $20,000 of accumulated earnings and profits. During the year the corporation distributes $28,000 in money to its shareholders and makes a distribution of property other than money with a fair market value and basis of $10,000. Since current earnings and profits are applied first to the distributions of money (see paragraphs (d) and (e) of § 1.1373–1), the entire distribution of $28,000 is a dividend out of current earnings and profits. In addition, since a distribution of previously taxed income cannot be made in property other than money, the property distribution is a dividend to the full extent of its value, $10,000, partly from current and partly from accumulated earnings and profits.

§ 1.1376 Statutory provisions; adjustment to basis of stock of, and indebtedness owing, shareholders.

SEC. 1376. *Adjustment to basis of stock of, and indebtedness owing, shareholders*—(a) *Increase in basis of stock for amounts treated as dividends.* The basis of a shareholder's stock in an electing small business corporation shall be increased by the amount required to be included in the gross income of such shareholder under section 1373(b), but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in any redetermination of the shareholder's tax liability.

(b) *Reduction in basis of stock and indebtedness for shareholder's portion of corporation net operating loss*—(1) *Reduction in basis of stock.* The basis of a shareholder's stock in an electing small business corporation shall be reduced (but not below zero) by an amount equal to the amount of his portion of the corporation's net operating loss for any taxable year attributable to such stock (as determined under section 1374(c)).

(2) *Reduction in basis of indebtedness.* The basis of any indebtedness of an electing small business corporation to a shareholder of such corporation shall be reduced (but not below zero) by an amount equal to the amount of the shareholder's portion of the corporation's net operating loss for any taxable year (as determined under section 1374(c)), but only to the extent that such amount exceeds the adjusted basis of the stock of such corporation held by the shareholder.

[Sec. 1376 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1655)]

§ 1.1376–1 Adjustment to basis of stock of, and indebtedness to, shareholders; increase in basis of stock.

Under section 1376(a), the basis of a shareholder's stock in an electing small business corporation is increased by the amount required to be included in the gross income of such shareholder under section 1373(b), but only to the extent to which such amount is actually included in his gross income in his income tax return (unless under section 6012(a)(1) the shareholder is not required to file a return), increased or decreased by any adjustment of such amount in any redetermination of the shareholder's tax liability. The effect of this rule is the same as if, on the last day of the corporation's taxable year, such amount had actually been distributed as a dividend and then reinvested by such shareholder. This increase in basis will affect only those shares of stock of the electing small business corporation which the shareholder owned at the end of the corporation's taxable year and is apportioned in equal amounts to each such share. The increase is effective as of such last day, and survives a termination of the corporation's election. See section 1372(b)(2).

§ 1.1376–2 Reduction in basis of stock and indebtedness.

(a) *Reduction in basis of stock*—(1) *In general.* Under section 1376(b)(1), the basis of a shareholder's stock in an electing small business corporation is reduced by an amount equal to his portion of the corporation's net operating loss for any taxable year attributable to such stock. However, the basis of such stock is not to be reduced below zero.

(2) *Amount of reduction in basis of individual shares.* (i) The amount of the reduction in the basis of each share of stock shall be that portion of the shareholder's pro rata share of the corporation's net operating loss which is attributable to each such share under the rule in section 1374(c). In the event that the basis reduction applicable to a share of stock under the rule in the preceding sentence exceeds the basis of such share, the excess shall be applied in reduction of the basis of all other shares of stock owned by the same shareholder in proportion to the basis of such shares remaining after the application of the rule in the preceding sentence.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. A's pro rata share of the corporation's net operating loss for the taxable year is $100. This amount is attributable, under the rule of section 1374(c), to three shares of stock held by A during the taxable year; one of which was owned by him during the entire year and the other two of which were acquired by him in the middle of the year. The amount of the pro rata share of the loss attributable to each share is as follows:

Share No. 1 (owned for entire year)	$50
Share No. 2 (owned for one-half year)	25
Share No. 3 (owned for one-half year)	25

The reduction in basis of share No. 1 is $50, and the reduction in basis of shares No. 2 and No. 3 is $25 each. Assume that the adjusted basis of the three shares of stock prior to this reduction is as follows:

Share No. 1	$40
Share No. 2	45
Share No. 3	35

After the reduction in basis by the amount of the loss attributable to each share, the basis of the shares is as follows:

Share No. 1	$0
Share No. 2	20
Share No. 3	10

The $10 excess of the basis reduction allocable to share No. 1 over the basis of that share is applied to reduce the basis of shares No. 2 and No. 3 in proportion to their remaining basis. Therefore, $6.67 of such excess reduces the basis of share No. 2, and $3.33 of such excess reduces the basis of share No. 3. After this reduction the shares have the following basis:

Share No. 1	$0
Share No. 2	13.33
Share No. 3	6.67

(3) *Time of reduction.* (i) The reduction in the basis of stock provided under section 1376(b)(1) shall be effective as of the close of the corporation's taxable year in which the net operating loss was incurred as to stock which is held at such time and as of the close of the day before disposition if the stock was disposed of prior to that time.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. Corporation X, an electing small business corporation, is on a calendar year. On June 2, 1960, A, a shareholder in corporation X, sells 50 shares of stock which, without regard to section 1376(b)(1), have a basis of $10,000. At the end of 1960, it is determined that corporation X has a net operating loss for the year, and $1,000 of A's pro rata share of such loss is attributable to the 50 shares sold in June. The reduction in basis required by section 1376(b)(1) is effective as of the close of June 1, 1960, the day before the sale, and A's basis for purposes of determining gain or loss on the sale is $9,000.

(b) *Reduction in basis of indebtedness*—(1) *In general.* Under section 1376(b)(2), the basis of any indebtedness of an electing small business corporation to a shareholder is reduced by an amount equal to the shareholder's portion of the corporation's net operating loss for the taxable year, but only to the extent that such amount exceeds the basis of the shareholder's stock in the corporation. Thus, the amount of the shareholder's portion of the net operating loss is first applied in reduction of the basis of his stock in accordance with the rules of paragraph (a) of this section, and only the remainder, if any, reduces the basis of the indebtedness.

(2) *Indebtedness affected by basis reduction.* The reduction in the basis of indebtedness provided by section 1376(b)(2) shall apply to the indebtedness to the shareholder as of the close of the corporation's taxable year in which the net operating loss was incurred if the shareholder held stock in the corporation at such time, or, if the shareholder was not a shareholder at such time, then as of the close of the last day on which he was a shareholder.

(3) *Amount of reduction in basis of more than one indebtedness.* If more than one indebtedness is affected by the basis reduction provided by section 1376(b)(2), the reduction shall be applied to each such indebtedness in proportion to the basis of the various debts.

(4) *Time of reduction.* The reduction in the basis of indebtedness provided by section 1376(b)(2) shall be effective as of the close of the corporation's taxable year in which the net operating loss was incurred if the shareholder held stock in the corporation at that time, or, if the shareholder was not a shareholder at that time, then as of the last day on which he was a shareholder.

§ 1.1377 Statutory provisions; special rules applicable to earnings and profits of electing small business corporations.

SEC. 1377. *Special rules applicable to earnings and profits of electing small business corporations*—(a) *Reduction for undistributed taxable income.* The accumulated earnings and profits of an electing small business corporation as of the close of its taxable year shall be reduced to the extent that its undistributed taxable income for such year is required to be included in the gross income of the shareholders of such corporation under section 1373(b).

(b) *Current earnings and profits not reduced by any amount not allowable as deduction.* The earnings and profits of an electing small business corporation for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income (as provided in section 1373(d)) for such taxable year.

(c) *Earnings and profits not affected by net operating loss.* The earnings and profits and the accumulated earnings and profits of an electing small business corporation shall not be affected by any item of gross income or any deduction taken into account in determining the amount of any net operating loss (computed as provided in section 1374(c)) of such corporation.

[Sec. 1377 as added by sec. 64(a), Technical Amendments Act 1958 (72 Stat. 1656)]

§ 1.1377–1 Reduction of earnings and profits for undistributed taxable income.

Section 1377(a) provides that the accumulated earnings and profits of an electing small business corporation as of the close of its taxable year shall be reduced to the extent that its undistributed taxable income for such year is required to be included in the gross income of shareholders under section 1373(b). See section 1375(d) and paragraph (a) of § 1.1375–4 for the correlative rule that distributions of previously taxed income do not reduce earnings and profits.

§ 1.1377–2 Current earnings and profits not reduced by any amount not allowable as a deduction.

(a) *Amounts not deductible.* (1) The earnings and profits of an electing small business corporation for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year.

(2) The application of this paragraph may be illustrated by the following examples:

Example (1). Corporation X has $300,000 of accumulated earnings and profits as of the beginning of the taxable year. It would have had earnings and profits of $400,000 for the taxable year (taking into account a net capital loss of $100,000, which amount was not deductible in determining its taxable income) but because it is an electing small business corporation it has earnings and profits of $500,000 for the taxable year. If the corporation makes a dividend distribution during the year in the amount of $500,000, all of such amount will be considered a distribution of current earnings and profits. However, the corporation will have only $200,000 of accumulated earnings and profits as of the beginning of the following taxable year.

Example (2). Assume the same facts as in example (1), except that the corporation does not have any accumulated earnings and profits as of the beginning of the taxable year. The entire $500,000 distribution is a distribution of current earnings and profits. As of the beginning of the year following the taxable year in which the $500,000 distribution was made, the corporation has neither accumulated earnings and profits nor a deficit in accumulated earnings and profits. It would begin such year with its paid-in capital reduced by $100,000.

(b) *Computation of earnings and profits.* Except as otherwise provided in section 1377, the earnings and profits of the taxable year of an electing small business corporation are computed in the same manner as the earnings and profits of corporations generally. Therefore, such earnings and profits can exceed the taxable income of the corporation, as in the case of a corporation which uses percentage depletion in computing its taxable income or which receives tax-exempt interest on certain governmental obligations.

§ 1.1377–3 Earnings and profits not affected by net operating loss.

(a) *Net operating loss.* Under section 1377(c), the current earnings and profits and the accumulated earnings and profits of an electing small business corporation are not affected by any item of gross income or any deduction taken into account in determining the amount of any net operating loss (computed as provided in section 1374(c)(1)) of such corporation.

(b) *Example.* The application of this section may be illustrated by the following example:

Example. At the beginning of its calendar year 1960, corporation X, an electing small business corporation, has accumulated earnings and profits of $50,000. During 1960, the corporation has $5,000 of gross income and deductible expenses of $15,000, which produce a $10,000 net operating loss for the taxable year. If corporation X were not an electing small business corporation, its accumulated earnings and profits as of January 1, 1961, would have been $40,000. However, since corporation X was an electing small business corporation for 1960, its accumulated earnings and profits are not affected by the income and deductions for 1960 because they are taken into account in determining the net operating loss. Accordingly, the accumulated earnings and profits of corporation X as of January 1, 1961, are $50,000.

Tax on Self-Employment Income

§ 1.1401 Statutory provisions; rate of tax on self-employment income.

SEC. 1401. *Rate of tax.* In addition to other taxes, there shall be imposed for each taxable year, on the self-employment income of every individual, a tax as follows:

(1) In the case of any taxable year beginning before January 1, 1960, the tax shall be equal to 3 percent of the amount of the self-employment income for such taxable year;

(2) In the case of any taxable year beginning after December 31, 1959, and before January 1, 1965, the tax shall be equal to 3¾ percent of the amount of the self-employment income for such taxable year;

(3) In the case of any taxable year beginning after December 31, 1964, and before January 1, 1970, the tax shall be equal to 4½ percent of the amount of the self-employment income for such taxable year;

(4) In the case of any taxable year beginning after December 31, 1969, and before January 1, 1975, the tax shall be equal to 5¼ percent of the amount of the self-employment income for such taxable year;

(5) In the case of any taxable year beginning after December 31, 1974, the tax shall be equal to 6 percent of the amount of the self-employment income for such taxable year.

[Sec. 1401 as amended by sec. 208(a), Social Security Amendments 1954 (68 Stat. 1093)]

§ 1.1401–1 Tax on self-employment income.

(a) There is imposed, in addition to other taxes, a tax upon the self-employment income of every individual at the rates prescribed in section 1401. This tax shall be levied, assessed, and collected as part of the income tax imposed by subtitle A of the Code, and, except as otherwise expressly provided, will be included with the tax imposed by section 1 or 3 in computing any deficiency or overpayment and in computing the interest and additions to any deficiency, overpayment, or tax. Since the tax on self-employment income is part of the income tax, it is subject to the jurisdiction of the Tax Court of the United States to the same extent and in the same manner as the other taxes under subtitle A of the Code. However, this tax is not required to be taken into account in computing any estimate of the

taxes required to be declared under section 6015.

(b) In general, self-employment income consists of the net earnings derived by an individual (other than a nonresident alien) from a trade or business carried on by him as sole proprietor or by a partnership of which he is a member, including the net earnings of certain employee newsboys and certain employee ministers and members of religious orders. See, however, the exclusions, exceptions, and limitations set forth in §§ 1.1402 (a)–1 through 1.1402 (e)–1.

§ 1.1402(a) Statutory provisions; definitions; net earnings from self-employment.

SEC. 1402. *Definitions*—(a) *Net earnings from self-employment.* The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702 (a) (9) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

(1) There shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer;

(2) There shall be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), unless such dividends and interest (other than interest described in section 35) are received in the course of a trade or business as a dealer in stocks or securities;

(3) There shall be excluded any gain or loss—

(A) Which is considered as gain or loss from the sale or exchange of a capital asset,

(B) From the cutting of timber, or the disposal of timber or coal, if section 631 applies to such gain or loss, or

(C) From the sale, exchange, involuntary conversion, or other disposition of property if such property is neither—

(i) Stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor

(ii) Property held primarily for sale to customers in the ordinary course of the trade or business;

(4) The deduction for net operating losses provided in section 172 shall not be allowed;

(5) If—

(A) Any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife; and

(B) Any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner;

(6) A resident of Puerto Rico shall compute his net earnings from self-employment in the same manner as a citizen of the United States but without regard to section 933;

(7) The deduction for personal exemptions provided in section 151 shall not be allowed;

(8) An individual who is—

(A) A duly ordained, commissioned, or licensed minister of a church or a member of a religious order; and

(B) A citizen of the United States performing service described in subsection (c) (4) as an employee of an American employer (as defined in section 3121 (h))

shall compute his net earnings from self-employment derived from the performance of service described in subsection (c) (4) without regard to section 911 (relating to earned income from sources without the United States) and section 931 (relating to income from sources within possessions of the United States).

If the taxable year of a partner is different from that of the partnership, the distributive share which he is required to include in computing his net earnings from self-employment shall be based on the ordinary income or loss of the partnership for any taxable year of the partnership ending within or with his taxable year. In the case of any trade or business which is carried on by an individual who reports his income on a cash receipts and disbursements basis, and in which, if it were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121 (g), (i) if the gross income derived from such trade or business by such individual is not more than $1,800, the net earnings from self-employment derived by him therefrom may, at his option, be deemed to be 50 percent of such gross income in lieu of his net earnings from self-employment from such trade or business computed as provided under the preceding provisions of this subsection, or (ii) if the gross income derived from such trade or business by such individual is more than $1,800 and the net earnings from self-employment derived by him therefrom, as computed under the preceding provisions of this subsection, are less than $900, such net earnings may instead, at the option of such individual, be deemed to be $900. For the purpose of the preceding sentence, gross income derived from such trade or business shall mean the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the preceding provisions of this subsection.

[Sec. 1402 (a) as amended by sec. 201 (a) and (c) (4), Social Security Amendments 1954 (68 Stat. 1087, 1089)]

§ 1.1402(a)–1 Net earnings from self-employment.

(a) *Definition.* (1) Subject to the special rules set forth in paragraph (c) of this section and to the exclusions set forth in § 1.1402(c)–1, the term "net earnings from self-employment" means—

(i) The gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by chapter 1 of the Code which are attributable to such trade or business, plus

(ii) His distributive share (whether or not distributed), as determined under section 704, of the income (or minus the loss), described in section 702 (a) (9) and as computed under section 703, from any trade or business carried on by any partnership of which he is a member.

(2) Gross income derived by an individual from a trade or business includes payments received by him from a partnership of which he is a member for services rendered to the partnership or for the use of capital by the partnership, to the extent the payments are determined without regard to the income of the partnership. However, such payments received from a partnership not engaged in a trade or business within the meaning of section 1402 (c) and § 1.1402 (c)–1 do not constitute gross income derived by an individual from a trade or business. See section 707 (c) and the regulations thereunder, relating to guaranteed payments to a member of a partnership for services or the use of capital. See also section 706 (a) and the regulations thereunder, relating to the taxable year of the partner in which such guaranteed payments are to be included in computing taxable income.

(3) Gross income derived by an individual from a trade or business includes gross income received (in the case of an individual reporting income on the cash receipts and disbursements method) or accrued (in the case of an individual reporting income on the accrual method) in the taxable year from a trade or business even though such income may be attributable in whole or in part to services rendered or other acts performed in a prior taxable year as to which the individual was not subject to the tax on self-employment income.

(b) *Computation of net earnings*—(1) *General rule.* In general, the gross income and deductions of an individual attributable to a trade or business (including a trade or business conducted by an employee referred to in paragraph (c) (1) or (2) of § 1.1402 (c)–1), for the purpose of ascertaining his net earnings from self-employment, are to be determined by reference to the provisions of law and regulations applicable with respect to the taxes imposed by sections 1 and 3. Thus, if an individual uses the accrual method of accounting in computing taxable income from a trade or business for the purpose of the tax imposed by section 1 or 3, he must use the same method in determining net earnings from self-employment. Likewise, if a taxpayer engaged in a trade or business of selling property on the installment plan elects, under the provisions of section 453, to use the installment method in computing income for purposes of the tax under section 1 or 3, he must use the same method in determining net earnings from self-employment. Except as otherwise provided in paragraph (c) (6) of this section, relating to certain residents of Puerto Rico, and in paragraph (c) (8) of this section, relating to ministers or members of religious orders, income which is exclud-

able from gross income under any provision of subtitle A of the Code is not taken into account in determining net earnings from self-employment. Thus, in the case of a citizen of the United States conducting, in a foreign country, a trade or business in which both personal services and capital are material income-producing factors, any part of the income therefrom which is excluded from gross income as earned income under the provisions of section 911 and the regulations thereunder is not taken into account in determining net earnings from self-employment.

(2) *Trade or business carried on.* The trade or business must be carried on by the individual, either personally or through agents or employees. Accordingly, income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust.

(3) *Aggregate net earnings.* Where an individual is engaged in more than one trade or business within the meaning of section 1402 (c) and § 1.1402 (c)–1, his net earnings from self-employment consist of the aggregate of the net income and losses (computed subject to the special rules provided in this section) of all such trades or businesses carried on by him. Thus, a loss sustained in one trade or business carried on by an individual will operate to offset the income derived by him from another trade or business.

(4) *Partnerships.* The net earnings from self-employment of an individual include, in addition to the earnings from a trade or business carried on by him, his distributive share of the income or loss, described in section 702 (a) (9), from any trade or business carried on by each partnership of which he is a member. An individual's distributive share of such income or loss of a partnership shall be determined as provided in section 704, subject to the special rules set forth in section 1402 (a) and in this section and to the exclusions provided in section 1402 (c) and in § 1.1402 (c)–1. For provisions relating to the computation of the taxable income of a partnership, see section 703.

(5) *Different taxable years.* If the taxable year of a partner differs from that of the partnership, the partner shall include, in computing net earnings from self-employment, his distributive share of the income or loss, described in section 702 (a) (9), of the partnership for its taxable year ending with or within the taxable year of the partner.

(6) *Meaning of partnerships.* For the purpose of determining net earnings from self-employment, a partnership is one which is recognized as such for income tax purposes. For income tax purposes, the term "partnership" includes not only a partnership as known at common law, but, also, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any trade or business, financial operation, or venture, and which is not, within the meaning of the Code, a trust, estate, or a corporation. An organization described in the preceding sentence shall be treated as a partnership for purposes of the tax on self-employment income even though such organization has elected, pursuant to section 1361 and the regulations thereunder, to be taxed as a domestic corporation.

(7) *Nature of partnership interest.* The net earnings from self-employment of a partner include his distributive share of the income or loss, described in section 702 (a) (9), of the partnership of which he is a member, irrespective of the nature of his membership. Thus, in determining his net earnings from self-employment, a limited or inactive partner includes his distributive share of such partnership income or loss. In the case of a partner who is a member of a partnership, with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation, net earnings from self-employment include his distributive share of the income or loss, described in section 702 (a) (9), from the trade or business carried on by the partnership computed without regard to the fact that the partnership has elected to be taxed as a domestic corporation.

(8) *Proprietorship taxed as domestic corporation.* A proprietor of an unincorporated business enterprise with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation shall compute his net earnings from self-employment without regard to the fact that such election has been made.

(c) *Special rules for computing net earnings.* For the purpose of computing net earnings from self-employment, the gross income derived by an individual from a trade or business carried on by him, the allowable deductions attributable to such trade or business, and the individual's distributive share of the income or loss, described in section 702 (a) (9), from any trade or business carried on by a partnership of which he is a member shall be computed in accordance with the following special rules:

(1) *Rentals from real estate.* (i) Rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) and the deductions attributable thereto, unless such rentals are received by an individual in the course of a trade or business as a real-estate dealer, are excluded. Whether or not an individual is engaged in the trade or business of a real-estate dealer is determined by the application of the principles followed in respect of the taxes imposed by sections 1 and 3. In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer. Where a real-estate dealer holds real estate for investment or speculation in addition to real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, only the rentals from the real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, and the deductions attributable thereto, are included in determining net earnings from self-employment; the rentals from the real estate held for investment or speculation, and the deductions attributable thereto, are excluded. Rentals paid in crop shares include income derived by an individual as the owner or lessee of land under an agreement entered into with another person pursuant to which such other person undertakes to produce a crop or livestock on such land and pursuant to which (*a*) the crop or livestock, or the proceeds thereof, are to be divided between such individual and such other person, and (*b*) the amount of such individual's share depends on the amount of the crop or livestock produced.

(ii) Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple-housing units are generally rentals from real estate. Except in the case of real-estate dealers, such payments are excluded in determining net earnings from self-employment even though such payments are in part attributable to personal property furnished under the lease.

(iii) Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or payments for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rentals from real estate; consequently, such payments are included in determining net earnings from self-employment. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas, the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and so forth, are not considered as services rendered to the occupant.

(iv) Except in the case of a real-estate dealer, where an individual or a partnership is engaged in a trade or business the income of which is classifiable in part as rentals from real estate, only that portion of such income which is not classifiable as rentals from real estate, and the expenses attributable to such portion, are included in determining net earnings from self-employment.

(v) The application of this subparagraph may be illustrated by the following example:

Example. A, an individual, owns a building containing four apartments. During the taxable year, he receives $1,400 from apartments numbered 1 and 2, which are rented without services rendered to the occupants, and $3,600 from apartments numbered 3 and 4, which are rented with services rendered to the occupants. His fixed expenses for the

four apartments aggregate $1,200 during the taxable year. In addition, he has $500 of expenses attributable to the services rendered to the occupants of apartments 3 and 4. In determining his net earnings from self-employment, A includes the $3,600 received from apartments 3 and 4, and the expenses of $1,100 ($500 plus ½ of $1,200) attributable thereto. The rentals and expenses attributable to apartments 1 and 2 are excluded. Therefore, A has $2,500 of net earnings from self-employment for the taxable year from the building.

(2) *Dividends and interest.* (i) All dividends on shares of stock are excluded unless they are received by an individual in the course of his trade or business as a dealer in stocks or securities.

(ii) Interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), is excluded unless such interest is received in the course of a trade or business as a dealer in stocks or securities. However, interest with respect to which a credit against tax is allowable as provided in section 35, that is, interest on certain obligations of the United States and its instrumentalities, is not included in net earnings from self-employment even though received in the course of a trade or business as a dealer in stocks or securities. Only interest on bonds, debentures, notes, or certificates, or other evidence of indebtedness, issued with interest coupons or in registered form by a corporation, is excluded in the case of all persons other than dealers in stocks or securities; other interest received in the course of any trade or business (such as interest received by a pawnbroker on his loans or interest received by a merchant on his accounts or notes receivable) is not excluded.

(iii) Dividends and interest of the character excludable under the preceding subdivisions of this subparagraph received by an individual on stocks or securities held for speculation or investment are excluded whether or not the individual is a dealer in stocks or securities.

(iv) A dealer in stocks or securities is a merchant of stocks or securities with an established place of business, regularly engaged in the business of purchasing stocks or securities and reselling them to customers; that is, he is one who as a merchant buys stocks or securities and sells them to customers with a view to the gains and profits that may be derived therefrom. Persons who buy and sell or hold stocks or securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, are not dealers in stocks or securities.

(3) *Gain or loss from disposition of property.* (i) There is excluded any gain or loss: (*a*) Which is considered as gain or loss from the sale or exchange of a capital asset; (*b*) from the cutting of timber or the disposal of timber or the disposal of coal, even though held primarily for sale to customers, if section 631 is applicable to such gain or loss; and (*c*) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither (*1*) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor (*2*) property held primarily for sale to customers in the ordinary course of a trade or business. For the purpose of the special rule in (*c*) of this subdivision, it is immaterial whether a gain or loss is treated as a capital gain or loss or as an ordinary gain or loss for purposes other than determining net earnings from self-employment. For instance, where the character of a loss is governed by the provisions of section 1231, such loss is excluded in determining net earnings from self-employment even though such loss is treated under section 1231 as an ordinary loss. For the purposes of this special rule, the term "involuntary conversion" means a compulsory or involuntary conversion of property into other property or money as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof; and the term "other disposition" includes the destruction or loss, in whole or in part, of property by fire, storm, shipwreck, or other casualty, or by theft, even though there is no conversion of such property into other property or money.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. During the taxable year 1954, A, who owns a grocery store, realized a net profit of $1,500 from the sale of groceries and a gain of $350 from the sale of a refrigerator case. During the same year, he sustained a loss of $2,000 as a result of damage by fire to the store building. In computing taxable income, all of these items are taken into account. In determining net earnings from self-employment, however, only the $1,500 of profit derived from the sale of groceries is included. The $350 gain and the $2,000 loss are excluded.

(4) *Net operating loss deduction.* The deduction provided by section 172, relating to net operating losses sustained in years other than the taxable year, is excluded.

(5) *Community income*—(i) *In case of an individual.* If any of the income derived by an individual from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income, and the deductions attributable to such income, shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife. For the purpose of this special rule, the term "management and control" means management and control in fact, not the management and control imputed to the husband under the community property laws. For example, a wife who operates a beauty parlor without any appreciable collaboration on the part of her husband will be considered as having substantially all of the management and control of such business despite the provision of any community property law vesting in the husband the right of management and control of community property; and the income and deductions attributable to the operation of such beauty parlor will be considered the income and deductions of the wife.

(ii) *In case of a partnership.* Even though a portion of a partner's distributive share of the income or loss, described in section 702 (a) (9), from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner; no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner. In any case in which both spouses are members of the same partnership, the distributive share of the income or loss of each spouse is included in computing the net earnings from self-employment of that spouse.

(6) *Puerto Rico*—(i) *Residents.* A resident of Puerto Rico, whether or not a bona fide resident thereof during the entire taxable year, and whether or not an alien, a citizen of the United States, or a citizen of Puerto Rico, shall compute his net earnings from self-employment in the same manner as would a citizen of the United States residing in the United States. See paragraph (d) of § 1.1402 (b)–1 for regulations relating to nonresident aliens. For the purpose of the tax on self-employment income, the gross income of such a resident of Puerto Rico also includes income from Puerto Rican sources. Thus, under this special rule, income from Puerto Rican sources will be included in determining net earnings from self-employment of a resident of Puerto Rico engaged in the active conduct of a trade or business in Puerto Rico despite the fact that, under section 933, such income may not be taken into account for purposes of the tax under section 1 or 3.

(ii) *Nonresidents.* A citizen of Puerto Rico who is also a citizen of the United States and who is not a resident of Puerto Rico will compute his net earnings from self-employment in the same manner and subject to the same provisions of law and regulations as other citizens of the United States.

(7) *Personal exemption deduction.* The deduction provided by section 151, relating to personal exemptions, is excluded.

(8) *Ministers and members of religious orders.* (i) For each taxable year ending after 1954 in which a minister or member of a religious order is engaged in a trade or business, within the meaning of section 1402 (c) and paragraph (e) of § 1.1402 (c)–1, with respect to service performed in the exercise of his ministry or in the exercise of duties required by such order, net earnings from self-employment from such trade or business include the gross income derived during the taxable year from any such service, less the deductions attributable to such gross income. If a minister or member of a religious order engaged in such a trade or business is a citizen of the United

States and performs service, in his capacity as a minister or member of a religious order, as an employee of an American employer, as defined in section 3121 (h) and subdivision (ii) of this subparagraph, his net earnings for self-employment derived from such service shall be computed without regard to the exclusions from gross income provided in section 911, relating to earned income from sources without the United States, and section 931, relating to income from sources within possessions of the United States. Thus, even though all the income of the minister or member for service of the character to which this subparagraph is applicable was derived from sources without the United States, or from sources within possessions of the United States, and therefore may be excluded from gross income, such income is included in computing net earnings from self-employment.

(ii) For the purpose of this subparagraph, the term "American employer" means an employer which is—

(*a*) The United States or any instrumentality thereof,

(*b*) An individual who is a resident of the United States (that is, the several States, the District of Columbia, the Territories of Alaska and Hawaii, the Virgin Islands, and Puerto Rico),

(*c*) A partnership, if two-thirds or more of the partners are residents of the United States,

(*d*) A trust, if all of the trustees are residents of the United States, or

(*e*) A corporation organized under the laws of the United States or of any State (including the District of Columbia, the Territories of Alaska and Hawaii, the Virgin Islands, and Puerto Rico).

(9) *Income from agricultural activity*—(i) *Taxable years ending before 1955.* (*a*) Income derived in a taxable year ending before 1955 from any trade or business in which, if the trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121 (g), and all deductions attributable to such income, are excluded. In case the services are in part agricultural and in part nonagricultural, the time devoted to the performance of each type of service is the test to be used to determine whether the major portion of the services would constitute agricultural labor. If more than half of the time spent in performing all the services is spent in performing services which would constitute agricultural labor under section 3121 (g), all income, and the deductions attributable to the income, shall be excluded. If only half, or less, of the time spent in performing all the services is spent in performing services which would constitute agricultural labor under section 3121 (g), all income, and the deductions attributable to the income, shall be included. In every case the time spent in performing the services will be computed by adding the time spent in the trade or business during the taxable year by every individual (including the individual carrying on such trade or business and the members of his family) in performing such services. The operation of this special rule is not affected by section 3121 (c), relating to the included-excluded rule for determining employment.

(*b*) The rules prescribed in (*a*) of this subdivision have no application where the nonagricultural services are performed in connection with an enterprise which constitutes a trade or business separate and distinct from the trade or business conducted as an agricultural enterprise. Thus, the operation of a roadside automobile service station on farm premises constitutes a trade or business separate and distinct from the agricultural enterprise, and the gross income derived from such service station, less the deductions attributable thereto, is to be taken into account in determining net earnings from self-employment.

(ii) *Taxable years ending after 1954.* Income derived in a taxable year ending after 1954 from agricultural activities (see subdivision (i) of this subparagraph) is includible in computing net earnings from self-employment. Income derived from agricultural activities includes income derived by an individual under an agreement entered into by such individual with another person pursuant to which such individual undertakes to produce a crop or livestock on land owned or leased by such other person and pursuant to which (*a*) the crop or livestock produced by such individual, or the proceeds thereof, are to be divided between such individual and such other person, and (*b*) the amount of such individual's share depends on the amount of the crop or livestock produced. However, the income derived under such an agreement by the owner or lessee of the land is not includible in computing net earnings from self-employment. See subparagraph (1) of this paragraph. For options relating to the computation of net earnings from self-employment, see paragraph (d) of this section.

(d) *Options available to farmers in computing net earnings from self-employment for taxable years ending after 1954*—(1) *Computation of net earnings.* In the case of any trade or business which is carried on by an individual who reports his income on the cash receipts and disbursements method, and in which, if it were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121 (g) (see paragraph (c) (9) (i) of this section), net earnings from self-employment may, for a taxable year ending after 1954, at the option of the taxpayer, be computed as follows:

(i) *Gross income $1,800 or less.* If the gross income, computed as provided in subparagraph (2) of this paragraph, from such trade or business is $1,800 or less, the taxpayer may, at his option, treat as net earnings from self-employment from such trade or business an amount equal to 50 percent of such gross income. If the taxpayer so elects, the amount equal to 50 percent of such gross income shall be used in computing his self-employment income in lieu of his actual net earnings from such trade or business, if any.

(ii) *Gross income in excess of $1,800.* If the gross income, computed as provided in subparagraph (2) of this paragraph, from such trade or business is more than $1,800, and the actual net earnings from self-employment from such trade or business are less than $900, the taxpayer may, at his option, treat $900 as net earnings from self-employment. If the taxpayer so elects, $900 shall be used in computing his self-employment income in lieu of his actual net earnings from such trade or business, if any. However, if the taxpayer's actual net earnings from such trade or business, as computed in accordance with paragraphs (a), (b), and (c) of this section, are $900 or more, such actual net earnings shall be used in computing his self-employment income.

(2) *Computation of gross income.* For purposes of subparagraph (1) of this paragraph, gross income shall consist of the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the provisions of paragraph (c) of this section, relating to income and deductions not included in computing net earnings from self-employment.

(3) *Examples.* Application of the regulations prescribed in subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). F, a farmer, uses the cash receipts and disbursements method of accounting in making his income tax returns. F's books and records show that during the calendar year 1955 he received $1,200 from the sale of produce raised on the farm, $200 from the sale of livestock raised on the farm and not held for breeding or dairy purposes, and $600 from the sale of a tractor. The income from the sale of the tractor is of a type which is excluded from net earnings from self-employment by section 1402 (a). F's actual net earnings from self-employment, computed in accordance with the provisions of paragraphs (a), (b), and (c) of this section, are $450. F may report $450 as his net earnings from self-employment or he may elect to report $700 (one-half of $1,400).

Example (2). C, a cattleman, uses the cash receipts and disbursements method of accounting in making his income tax returns. C had actual net earnings from self-employment, computed in accordance with the provisions of paragraphs (a), (b), and (c) of this section, of $725. His gross receipts were $1,000 from the sale of produce raised on the farm and $1,200 from the sale of feeder cattle, which C bought for $500. The income from the sale of the feeder cattle is of a type which is included in computing net earnings from self-employment. Therefore, C may report $725 as his net earnings from self-employment or he may elect to report $850, one-half of $1,700 ($2,200 minus $500).

Example (3). R, a rancher, has gross income of $3,000 from the operation of his ranch, computed as provided in subparagraph (2) of this paragraph. His actual net earnings from self-employment from farming activities are less than $900. R, nevertheless, may elect to report $900 as net earnings from self-employment from such trade or business. If R had actual net earnings from self-employment from his farming activities in the amount of $900 or more, he would be required to report such amount in computing his self-employment income.

(4) *Two or more agricultural activities.* If an individual is engaged in more

than one agricultural trade or business within the meaning of paragraph (c) (9) (i) of this section (for example, the business of ordinary farming and the business of cotton ginning), the gross income derived from each agricultural trade or business shall be aggregated for purposes of the optional method provided in subparagraph (1) of this paragraph for computing net earnings from self-employment.

(5) *Exercise of option.* A taxpayer shall, for each taxable year with respect to which he is eligible to use the optional method provided by subparagraph (1) of this paragraph, make a determination as to whether his net earnings from self-employment are to be computed in accordance with the optional method. If the taxpayer elects the optional method for a taxable year, he shall signify such election by computing net earnings from self-employment under the optional method as set forth in Schedule F (Form 1040) of the income tax return filed by the taxpayer for such taxable year. If the optional method is not elected at the time of the filing of the return for a taxable year with respect to which the taxpayer is eligible to elect such optional method, such method may be elected on an amended return (or on such other form as may be prescribed for such use) filed within the period prescribed by section 6501 and the regulations thereunder for the assessment of the tax for such taxable year. If the optional method is elected on a return for a taxable year, the taxpayer may revoke such election by filing an amended return (or such other form as may be prescribed for such use) for the taxable year within the period prescribed by section 6501 and the regulations thereunder for the assessment of the tax for such taxable year. If the taxpayer is deceased or unable to make a return, the person designated in section 6012 (b) and the regulations thereunder may, within the period prescribed in this subparagraph, elect the optional method for any taxable year with respect to which the taxpayer is eligible to use the optional method and revoke an election previously made by or for the taxpayer.

(6) *Members of farm partnerships.* The optional method provided by subparagraph (1) of this paragraph for computing net earnings from self-employment is not available to a member of a partnership with respect to his distributive share of the income or loss from any trade or business carried on by any partnership of which he is a member.

§ 1.1402(b) Statutory provisions; definitions; self-employment income.

SEC. 1402. *Definitions.* • • •

(b) *Self-employment income.* The term "self-employment income" means the net earnings from self-employment derived by an individual (other than a nonresident alien individual) during any taxable year; except that such term shall not include—

(1) That part of the net earnings from self-employment which is in excess of—

(A) For any taxable year ending prior to 1955, (i) $3,600, minus (ii) the amount of the wages paid to such individual during the taxable year; and

(B) For any taxable year ending after 1954, (i) $4,200, minus (ii) the amount of the wages paid to such individual during the taxable year; or

(2) The net earnings from self-employment, if such net earnings for the taxable year are less than $400.

For purposes of clause (1), the term "wages" includes such remuneration paid to an employee for services included under an agreement entered into pursuant to the provisions of section 218 of the Social Security Act (relating to coverage of State employees), or under an agreement entered into pursuant to the provisions of section 3121 (l) (relating to coverage of citizens of the United States who are employees of foreign subsidiaries of domestic corporations), as would be wages under section 3121 (a) if such services constituted employment under section 3121 (b). An individual who is not a citizen of the United States but who is a resident of the Virgin Islands or a resident of Puerto Rico shall not, for purposes of this chapter be considered to be a nonresident alien individual.

[Sec. 1402 (b) as amended by sec. 201 (b), Social Security Amendments 1954 (68 Stat. 1088)]

§ 1.1402(b)–1 Self-employment income.

(a) *In general.* Except for the exclusions in paragraphs (b) and (c) of this section and the exception in paragraph (d) of this section, the term "self-employment income" means the net earnings from self-employment derived by an individual during a taxable year.

(b) *Maximum self-employment income.* (1) The maximum self-employment income of an individual for any taxable year (whether a period of 12 months or less) is $4,200, except that the maximum self-employment income for any taxable year ending before 1955 is $3,600. If an individual is paid wages as defined in section 3121 (a), the maximum self-employment income is the excess of $4,200 ($3,600 for a taxable year ending before 1955) over the amount of such wages. For example, if during the taxable year 1955 no such wages are paid and the individual has $5,000 of net earnings from self-employment, he has $4,200 of self-employment income for such taxable year. If, in addition to having $5,000 of net earnings from self-employment, such individual is paid $1,000 of such wages, he has only $3,200 of self-employment income for the taxable year.

(2) For the purpose of the limitation prescribed in subparagraph (1) of this paragraph, the term "wages" includes such remuneration paid to an employee for services covered by—

(i) An agreement entered into pursuant to section 218 of the Social Security Act (42 U. S. C. 418), which section provides for extension of the Federal old-age and survivors insurance system to State and local government employees under voluntary agreements between the States and the Secretary of Health, Education, and Welfare (Federal Security Administrator before April 11, 1953), or

(ii) An agreement entered into pursuant to the provisions of section 3121 (l), relating to coverage of citizens of the United States who are employees of foreign subsidiaries of domestic corporations,

as would be wages under section 3121 (a) if such services constituted employment under section 3121 (b). For an explanation of the term "wages", see Subpart B of part 31 of this chapter (Employment Tax Regulations).

(c) *Minimum net earnings from self-employment.* Self-employment income does not include the net earnings from self-employment of an individual when the amount of such earnings for the taxable year is less than $400. Thus, an individual having only $300 of net earnings from self-employment for the taxable year would not have any self-employment income. However, an individual having net earnings from self-employment of $400 or more for the taxable year may have less than $400 of self-employment income. This would occur in a case in which the amount of the individual's net earnings from self-employment is $400 or more for a taxable year and the amount of such net earnings from self-employment plus the amount of the wages received by the individual during that taxable year exceed $4,200 ($3,600 for taxable years ending before 1955). For example, if an individual has net earnings from self-employment of $1,000 for 1955 and also receives wages of $4,000 during that taxable year, his self-employment income for that taxable year is $200.

(d) *Nonresident aliens.* A nonresident alien individual never has self-employment income. For the purpose of the tax on self-employment income, an individual who is not a citizen of the United States but who is a resident of the Virgin Islands or of Puerto Rico is not considered to be a nonresident alien individual. While a nonresident alien individual who derives income from a trade or business carried on within the United States, Puerto Rico, or the Virgin Islands (whether by agents or employees, or by a partnership of which he is a member) may be subject to the applicable income tax provisions on such income, such nonresident alien individual will not be subject to the tax on self-employment income, since any net earnings which he may have from self-employment do not constitute self-employment income.

§ 1.1402(c) Statutory provisions; definitions; trade or business.

SEC. 1402. *Definitions.* • • •

(c) *Trade or business.* The term "trade or business", when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses), except that such term shall not include—

(1) The performance of the functions of a public office;

(2) The performance of service by an individual as an employee (other than service described in section 3121 (b) (14) (B) performed by an individual who has attained the age of 18 and other than service described in paragraph (4) of this subsection);

(3) The performance of service by an individual as an employee or employee representative as defined in section 3231;

(4) The performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order; or

(5) The performance of service by an individual in the exercise of his profession as a

physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, or Christian Science practitioner; or the performance of such service by a partnership.

The provisions of paragraph (4) shall not apply to service (other than service performed by a member of a religious order who has taken a vow of poverty as a member of such order) performed by an individual during the period for which a certificate filed by such individual under subsection (e) is in effect. The provisions of paragraph (5) shall not apply to service performed by an individual in the exercise of his profession as a Christian Science practitioner during the period for which a certificate filed by him under subsection (e) is in effect.

[Sec. 1402(c) as amended by secs. 201(c)(1), (2), and (5), and 205(e), Social Security Amendments 1954 (68 Stat. 1088, 1089, 1092)]

§ 1.1402(c)–1 Trade or business.

(a) *In general.* In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Except for the exclusions discussed in paragraphs (b), (c), (d), (e), and (f) of this section, the term "trade or business", for the purpose of the tax on self-employment income, shall have the same meaning as when used in section 162. An individual engaged in one of the excluded activities specified in this section may also be engaged in carrying on an included trade or business. Whether or not he is also engaged in an included trade or business will be dependent upon all of the facts and circumstances in the particular case.

(b) *Public office.* The performance of the functions of a public office does not constitute a trade or business. The term "public office" includes any elective or appointive office of the United States or any possession thereof, or of a State or its political subdivisions, or of a wholly owned instrumentality of any one or more of the foregoing. For example, the President, the Vice President, a governor, a mayor, the Secretary of State, a member of Congress, a State representative, a county commissioner, a judge, a county or city attorney, a marshal, a sheriff, a register of deeds, or a notary public performs the functions of a public office.

(c) *Employees.* The performance of service by an individual as an employee, as defined in the Federal Insurance Contributions Act (chapter 21 of the Code), with two exceptions, does not constitute a trade or business. The exceptions are as follows:

(1) Service performed by an individual, who has attained the age of 18, in, and at the time of, the sale of newspapers or magazines to ultimate consumers, under an arrangement under which the newspapers or magazines are to be sold by him at a fixed price, his compensation being based on the retention of the excess of such price over the amount at which the newspapers or magazines are charged to him, whether or not he is guaranteed a minimum amount of compensation for such service, or is entitled to be credited with the unsold newspapers or magazines turned back, and

(2) Service described in section 1402 (c) (4) performed by an individual during taxable years for which a certificate filed in accordance with the provisions of § 1.1402 (e)–1 is in effect. See also paragraph (e) of this section.

As to when an individual is an employee, see 26 CFR (1939) part 408 (Regulations 128) and subpart B of part 31 of this chapter (Employment Tax Regulations), both of which relate to the Federal Insurance Contributions Act.

(d) *Individuals under Railroad Retirement System.* The performance of service by an individual as an employee or employee representative as defined in section 3231 (b) and (c), respectively (see §§ 31.3231 (b)–1 and 31.3231 (c)–1 of part 31 of this chapter (Employment Tax Regulations)), that is, an individual covered under the railroad retirement system, does not constitute a trade or business.

(e) *Ministers and members of religious orders*—(1) *In general.* For taxable years ending before 1955, a duly ordained, commissioned, or licensed minister of a church or a member of a religious order is not engaged in carrying on a trade or business with respect to service performed by him in the exercise of his ministry or in the exercise of duties required by such order. However, for taxable years ending after 1954, any individual who is a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) may elect, as provided in § 1.1402 (e)–1, to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to service performed by him in his capacity as such a minister or member. If such a minister or a member of a religious order makes an election pursuant to § 1.1402 (e)–1, he is, with respect to service performed by him in such capacity, engaged in carrying on a trade or business for each taxable year to which the election is effective. An election by a minister or member of a religious order has no application to service performed by such minister or member which is not in the exercise of his ministry or in the exercise of duties required by such order.

(2) *Service by a minister in the exercise of his ministry.* (i) A certificate of election filed by a duly ordained, commissioned, or licensed minister of a church under the provisions of § 1.1402 (e)–1 has application only to service performed by him in the exercise of his ministry.

(ii) Except as provided in subparagraph (3) (iii) of this paragraph, service performed by a minister in the exercise of his ministry includes the ministration of sacerdotal functions and the conduct of religious worship, and the control, conduct, and maintenance of religious organizations (including the religious boards, societies, and other integral agencies of such organizations), under the authority of a religious body constituting a church or church denomination. The following rules are applicable in determining whether services performed by a minister are performed in the exercise of his ministry:

(*a*) Whether service performed by a minister constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of the particular religious body constituting his church or church denomination.

(*b*) Service performed by a minister in the control, conduct, and maintenance of a religious organization relates to directing, managing, or promoting the activities of such organization. Any religious organization is deemed to be under the authority of a religious body constituting a church or church denomination if it is organized and dedicated to carrying out the tenets and principles of a faith in accordance with either the requirements or sanctions governing the creation of institutions of the faith. The term "religious organization" has the same meaning and application as is given to the term for income tax purposes.

(*c*) (*1*) If a minister is performing service in the conduct of religious worship or the ministration of sacerdotal functions, such service is in the exercise of his ministry whether or not it is performed for a religious organization.

(*2*) The rule in (*c*) (*1*) of this subdivision may be illustrated by the following example:

Example. M, a duly ordained minister, is engaged to perform service as chaplain at N University. M devotes his entire time to performing his duties as chaplain which include the conduct of religious worship, offering spiritual counsel to the university students, and teaching a class in religion. M is performing service in the exercise of his ministry.

(*d*) (*1*) If a minister is performing service for an organization which is operated as an integral agency of a religious organization under the authority of a religious body constituting a church or church denomination, all service performed by the minister in the conduct of religious worship, in the ministration of sacerdotal functions, or in the control, conduct, and maintenance of such organization (see subdivision (ii) (*b*) of this subparagraph) is in the exercise of his ministry.

(*2*) The rule in (*d*) (*1*) of this subdivision may be illustrated by the following example:

Example. M, a duly ordained minister, is engaged by the N Religious Board to serve as director of one of its departments. He performs no other service. The N Religious Board is an integral agency of O, a religious organization operating under the authority of a religious body constituting a church denomination. M is performing service in the exercise of his ministry.

(*e*) (*1*) If a minister, pursuant to an assignment or designation by a religious body constituting his church, performs service for an organization which is neither a religious organization nor operated as an integral agency of a religious organization, all service performed by him, even though such service may not involve the conduct of religious worship or the ministration of sacerdotal functions, is in the exercise of his ministry.

(*2*) The rule in (*e*) (*1*) of this subdivision may be illustrated by the following example:

Example. M, a duly ordained minister, is assigned by X, the religious body constituting his church, to perform advisory service to Y Company in connection with the publication of a book dealing with the history of M's church denomination. Y is neither a religious organization nor operated as an integral agency of a religious organization. M performs no other service for X or Y. M is performing service in the exercise of his ministry.

(3) *Service by a minister not in the exercise of his ministry.* (i) A certificate filed by a duly ordained, commissioned, or licensed minister of a church under the provisions of § 1.1402 (e)–1 has no application to service performed by him which is not in the exercise of his ministry.

(ii) (*a*) If a minister is performing service for an organization which is neither a religious organization nor operated as an integral agency of a religious organization and the service is not performed pursuant to an assignment or designation by his ecclesiastical superiors, then only the service performed by him in the conduct of religious worship or the ministration of sacerdotal functions is in the exercise of his ministry. See, however, subdivision (iii) of this subparagraph.

(*b*) The rule in (*a*) of this subdivision may be illustrated by the following example:

Example. M, a duly ordained minister, is engaged by N University to teach history and mathematics. He performs no other service for N although from time to time he performs marriages and conducts funerals for relatives and friends. N University is neither a religious organization nor operated as an integral agency of a religious organization. M is not performing the service for N pursuant to an assignment or designation by his ecclesiastical superiors. The service performed by M for N University is not in the exercise of his ministry. However, service performed by M in performing marriages and conducting funerals is in the exercise of his ministry.

(iii) Service performed by a duly ordained, commissioned, or licensed minister of a church as an employee of the United States, or a State, Territory, or possession of the United States, or the District of Columbia, or a foreign government, or a political subdivision of any of the foregoing, is not considered to be in the exercise of his ministry for purposes of the tax on self-employment income, even though such service may involve the ministration of sacerdotal functions or the conduct of religious worship. Thus, for example, service performed by an individual as a chaplain in the Armed Forces of the United States is considered to be performed by a commissioned officer in his capacity as such, and not by a minister in the exercise of his ministry. Similarly, service performed by an employee of a State as a chaplain in a State prison is considered to be performed by a civil servant of the State and not by a minister in the exercise of his ministry.

(4) *Service in the exercise of duties required by a religious order.* A certificate of election filed by a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) under the provisions of § 1.1402 (e)–1 has application to all duties required of him by such order. The nature or extent of such service is immaterial so long as it is a service which he is directed or required to perform by his ecclesiastical superiors.

(f) *Members of certain professions—*(1) *Taxable years ending before 1955.* For taxable years ending before 1955, an individual is not engaged in carrying on a trade or business with respect to the performance of service in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, Christian Science practitioner, architect, certified public accountant, accountant registered or licensed as an accountant under State or municipal law, full-time practicing public accountant, funeral director, or professional engineer.

(2) *Taxable years ending after 1954.* (i) Except as provided in subdivision (ii) of this subparagraph, for taxable years ending after 1954 an individual is not engaged in carrying on a trade or business with respect to the performance of service in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, or Christian Science practitioner.

(ii) For taxable years ending after 1954, a Christian Science practitioner may elect, as provided in § 1.1402 (e)–1, to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to service performed by him in the exercise of his profession as a Christian Science practitioner. If an election is made pursuant to § 1.1402 (e)–1, the Christian Science practitioner is, with respect to the performance of service in the exercise of such profession, engaged in carrying on a trade or business for each taxable year to which the election is effective. An election by a Christian Science practitioner has no application to service performed by him which is not in the exercise of his profession as a Christian Science practitioner.

(3) *Legal requirements.* The exclusions specified in subparagraphs (1) and (2) of this paragraph apply only if the individuals meet the legal requirements, if any, for practicing their professions in the place where they perform the service. Thus, an individual who is not licensed as a veterinarian but who is publicly engaged in the practice of veterinary medicine in a jurisdiction which requires that an individual engaged in such practice be licensed is not within the exclusion.

(4) *Meaning of terms.* The designations in subparagraphs (1) and (2) of this paragraph are to be given their commonly accepted meaning. Thus, the term "physician" means an individual who is legally qualified to practice medicine, and the term "lawyer" means an individual who is legally qualified to practice law.

(5) *Partnerships.* In the case of a partnership engaged in the practice of any of the designated excluded professions, the partnership shall not be considered as carrying on a trade or business for the purpose of the tax on self-employment income, and none of the distributive shares of the income or loss, described in section 702 (a) (9), of such partnership shall be included in computing net earnings from self-employment of any member of the partnership. On the other hand, where a partnership is engaged in a trade or business not within any of the designated excluded professions, each partner must include his distributive share of the income or loss, described in section 702 (a) (9), of such partnership in computing his net earnings from self-employment, irrespective of whether such partner is engaged in the practice of one or more of such professions and contributes his professional services to the partnership.

§ 1.1402(d) Statutory provisions; definitions; employee and wages.

SEC. 1402. *Definitions.* • • •

(d) *Employee and wages.* The term "employee" and the term "wages" shall have the same meaning as when used in chapter 21 (sec. 3101 and following, relating to Federal Insurance Contributions Act).

§ 1.1402(d)–1 Employee and wages.

For the purpose of the tax on self-employment income, the term "employee" and the term "wages" shall have the same meaning as when used in the Federal Insurance Contributions Act. For an explanation of these terms, see 26 CFR (1939) part 408 (Regulations 128) and subpart B of part 31 of this chapter (Employment Tax Regulations).

§ 1.1402(e) Statutory provisions; definitions; ministers, members of religious orders, and Christian Science practitioners.

SEC. 1402. *Definitions.* • • •

(e) *Ministers, members of religious orders, and Christian Science practitioners—*(1) *Waiver certificate.* Any individual who is (A) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or (B) a Christian Science practitioner may file a certificate (in such form and manner, and with such official, as may be prescribed by regulations made under this chapter) certifying that he elects to have the insurance system established by title II of the Social Security Act extended to service described in subsection (c) (4), or service described in subsection (c) (5) insofar as it relates to the performance of service by an individual in the exercise of his profession as a Christian Science practitioner, as the case may be, performed by him.

(2) *Time for filing certificate.* Any individual who desires to file a certificate pursuant to paragraph (1) must file such certificate on or before the due date of the return (including any extension thereof) for his second taxable year ending after 1954 for which he has net earnings from self-employment (computed, in the case of an individual referred to in paragraph (1) (A), without regard to subsection (c) (4), and, in the case of an individual referred to in paragraph (1) (B), without regard to subsection (c) (5) insofar as it relates to the performance of service by an individual in the exercise of his profession as a Christian Science practitioner) of $400 or more, any part of which was derived from the performance of service described in subsection (c) (4), or from the performance of service described in subsection (c) (5) insofar as

it relates to the performance of service by an individual in the exercise of his profession as a Christian Science practitioner, as the case may be.

(3) *Effective date of certificate.* A certificate filed pursuant to this subsection shall be effective for the first taxable year with respect to which it is filed (but in no case shall the certificate be effective for a taxable year with respect to which the period for filing a return has expired, or for a taxable year ending prior to 1955) and all succeeding taxable years. An election made pursuant to this subsection shall be irrevocable.

[Sec. 1402(e) as added by sec. 201(c)(3), Social Security Amendments of 1954 (68 Stat. 1088)]

§ 1.1402(e)–1 Election by ministers, members of religious orders, and Christian Science practitioners for self-employment coverage.

(a) *In general.* Any individual who is (1) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or (2) a Christian Science practitioner may elect to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to service performed by him in the exercise of his ministry or in the exercise of duties required by such order, or in the exercise of his profession as a Christian Science practitioner, as the case may be. Such an election shall be made by filing a certificate on Form 2031 in the manner provided in paragraph (b) of this section and within the time specified in paragraph (c) of this section. If a minister or member to whom this paragraph has application, or a Christian Science practitioner, makes an election by filing Form 2031, such individual shall, for each taxable year to which the election is effective (see paragraph (d) of this section), be considered as carrying on a trade or business with respect to the performance of service in his capacity as such a minister or member, or as a Christian Science practitioner, as the case may be.

(b) *Waiver certificate.* (1) The certificate on Form 2031 shall be filed in triplicate with the district director for the internal revenue district in which is located the legal residence or principal place of business of the individual who executed the certificate. If such individual has no legal residence or principal place of business in the United States, Puerto Rico, or the Virgin Islands, such certificate shall be filed with the District Director of Internal Revenue, Baltimore 2, Maryland. The certificate must be filed within the time prescribed in paragraph (c) of this section. If an individual to whom this section has application submits to a district director a dated and signed statement indicating that he desires to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to his services, such statement will be treated as a waiver certificate, if filed within the time specified in paragraph (c) of this section, provided that without unnecessary delay such statement is supplemented by a properly executed Form 2031.

(2) An application for a social security account number filed on Form SS–5 or the filing of an income tax return showing an amount representing self-employment income or self-employment tax shall not be construed to constitute an election referred to in paragraph (a) of this section.

(c) *Time limitation for filing waiver certificate.* (1) (i) Any individual referred to in paragraph (a) of this section who desires to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to his services must file the waiver certificate (Form 2031) prescribed by paragraph (a) of this section on or before the due date of the income tax return (see section 6072), including any extension thereof (see section 6081), for his second taxable year ending after 1954 for which he has net earnings from self-employment (computed as prescribed in subparagraph (3) of this paragraph) of $400 or more, any part of which:

(*a*) In the case of a duly ordained, commissioned, or licensed minister of a church, consists of remuneration for service performed in the exercise of his ministry,

(*b*) In the case of a member of a religious order who has not taken a vow of poverty as a member of such order, consists of remuneration for services performed in the exercise of duties required by such order,

(*c*) In the case of a Christian Science practitioner, consists of remuneration for service performed in the exercise of his profession as a Christian Science practitioner.

Thus, a minister who performs service in the exercise of his ministry and who makes his income tax returns on the basis of a calendar year and has, for each of the calendar years 1955 and 1956, net earnings from self-employment of $400 or more (computed as prescribed in subparagraph (3) of this paragraph), a portion of which was derived from such service, may not make an election with respect to his service as a minister after the due date (April 15, 1957) prescribed for filing his income tax return for 1956, or any extension thereof. If a minister, a member of a religious order, or a Christian Science practioner receives remuneration in a taxable year for service performed in such capacity and the deductions allowed by chapter 1 of the Code, which are attributable to the portion of such remuneration which constitutes gross income, equal or exceed the amount of such gross income, no part of the net earnings from self-employment (computed as prescribed in subparagraph (3) of this paragraph) for such taxable year shall be considered to consist of remuneration for such service. See, however, paragraph (d) of this section for provisions relating to the effective period of the waiver certificate.

(ii) The application of the rule set forth in subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). M, a licensed minister, has been employed as a toolmaker by the XYZ Corporation for the taxable years 1955 and 1956 and also engages in activities as a minister on week-ends. M makes his income tax returns on the basis of a calendar year. During each of the taxable years 1955 and 1956, M received wages of $4,200 from the XYZ Corporation and derived $400 (all of which constituted net earnings from self-employment computed as prescribed in subparagraph (3) of this paragraph) from his activities as a minister. In such case, if M wishes to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to his services as a minister, he must file the waiver certificate on or before the due date (April 15, 1957) prescribed for filing his income tax return for 1956, or any extension thereof. A waiver certificate filed after such date will be invalid.

Example (2). M was ordained as a minister in May 1956. During each of the taxable years 1956 and 1958, M, who makes his income tax returns on a calendar year basis, derived net earnings in excess of $400 from his activities as a minister. M had net earnings of $350 for the taxable year 1957, $200 of which was derived from service performed by him as a minister. If M wishes to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to his service as a minister, he must file the waiver certificate on or before the due date (April 15, 1959) prescribed for filing his income tax return for 1958, or any extension thereof.

(2) The right of an individual to file a waiver certificate shall cease from his death. Thus, the surviving spouse, administrator, or executor of a decedent shall not be permitted to file a waiver certificate for such decedent.

(3) For the purpose of this paragraph, net earnings from self-employment shall be determined without regard to the fact that, without an election, the performance of services by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, or by a member of a religious order in the exercise of duties required by such order, or the performance of service by an individual in the exercise of his profession as a Christian Science practitioner, does not constitute a trade or business for purposes of the tax on self-employment income.

(d) *Effective date of waiver certificate.* (1) A certificate on Form 2031 filed in accordance with the provisions of this section shall be effective for the first taxable year with respect to which it is filed and all subsequent taxable years. A certificate must be made effective for either the first or second taxable year ending after 1954 in which the individual has net earnings from self-employment of $400 (determined as provided in paragraph (c) (3) of this section) from service of the character with respect to which an election may be made. However, a certificate on Form 2031 may not be effective, even though filed within the time specified in paragraph (c) (1) of this section, for any taxable year with respect to which the due date for filing the individual's income tax return (including any extension thereof) has expired at the time such certificate is filed. Further, a certificate on Form 2031 may not be effective for any taxable year ending before 1955. In order for an election

to be effective for the first or second taxable year ending after 1954 in which the individual has net earnings from self-employment (determined as provided in paragraph (c) (3) of this section) from service of the character with respect to which an election may be made, the certificate on Form 2031 must be filed on or before the due date for filing the income tax return of the individual for such first or second taxable year, or of any extension thereof. Thus, if an individual makes his income tax returns on a calendar year basis and the due date of his return for the calendar year 1955 is April 15, 1956, a waiver certificate, to be effective for the calendar year 1955, must be filed on or before April 15, 1956. If such individual files a certificate after April 15, 1956, and before the due date of his income tax return for 1956, the first taxable year for which the certificate may be effective is the calendar year 1956.

(2) If an individual makes an election to become effective beginning with respect to any taxable year, such election shall be effective with respect to such taxable year unless the individual, on or before the due date for filing the income tax return for such taxable year (including any extension thereof), files, with the district director with whom the certificate on Form 2031 was filed, a written notice of his desire to withdraw the certificate. If the individual is deceased or unable to make a return, the written notice of withdrawal of the certificate on Form 2031 may be filed for or on behalf of the individual by the person designated in section 6012(b) and the regulations thereunder. In the absence of a withdrawal of a certificate on or before the due date for filing the income tax return for the taxable year (including any extension thereof), the election shall be effective with respect to such taxable year and all subsequent taxable years provided all the provisions of this section are met.

(3) A certificate filed and intended to be effective for a particular taxable year which for any reason is ineffective for such taxable year shall become effective with respect to the next succeeding taxable year provided the requirements of paragraph (c) of this section are met with respect to such taxable year.

(4) An election which has become effective in accordance with the provisions of this section is irrevocable.

§ 1.1403 Statutory provisions; miscellaneous provisions.

SEC. 1403. *Miscellaneous provisions*—(a) *Title of chapter.* This chapter may be cited as the "Self-Employment Contributions Act of 1954".

(b) *Cross references.* (1) For provisions relating to returns, see section 6017.

(2) For provisions relating to collection of taxes in Virgin Islands and Puerto Rico, see section 7651.

§ 1.1403–1 Cross references.

For provisions relating to the requirement for filing returns with respect to net earnings from self-employment, see § 1.6017–1. For other administrative provisions relating to the tax on self-employment income, see the applicable sections of the regulations in this part (§ 1.6001–1 et seq.) and the applicable sections of the regulations in part 301 of this chapter (Regulations on Procedure and Administration).

Withholding of Tax on Nonresident Aliens and Foreign Corporations and Tax-Free Covenant Bonds

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

§ 1.1441 Statutory provisions; withholding of tax on nonresident aliens.

SEC. 1441. *Withholding of tax on nonresident aliens*—(a) *General rule.* Except as otherwise provided in subsection (c), all persons, in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States) having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual, or of any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, shall (except in the cases provided for in section 1451 and except as otherwise provided in regulations prescribed by the Secretary or his delegate under section 874) deduct and withhold from such items a tax equal to 30 percent thereof.

(b) *Income items.* The items of income referred to in subsection (a) are interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, and amounts described in section 402(a)(2), section 403(a)(2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets.

(c) *Exceptions*—(1) *Dividends of foreign corporations.* No deduction or withholding under subsection (a) shall be required in the case of dividends paid by a foreign corporation unless (A) such corporation is engaged in trade or business within the United States, and (B) more than 85 percent of the gross income of such corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under part I of subchapter N of chapter 1.

(2) *Owner unknown.* The Secretary or his delegate may authorize the tax under subsection (a) to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(3) *Bonds with extended maturity dates.* The deduction and withholding in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation, within subsections (a), (b), and (c) of section 1451 were it not for the fact that the maturity date of such obligations has been extended on or after January 1, 1934, and the liability assumed by the debtor exceeds 27½ percent of the interest, shall not exceed the rate of 27½ percent per annum.

(4) *Compensation of certain aliens.* Under regulations prescribed by the Secretary or his delegate, there may be exempted from deduction and withholding under subsection (a) the compensation for personal services of nonresident alien individuals who enter and leave the United States at frequent intervals.

(5) *Special items.* In the case of amounts described in section 402(a)(2), section 403(a)(2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets, the amount required to be deducted and withheld shall, if the amount of such gain is not known to the withholding agent, be such amount, not exceeding 30 percent of the proceeds from such sale or exchange, as may be necessary to assure that the tax deducted and withheld shall not be less than 30 percent of such gain.

(6) *Per diem of certain aliens.* No deduction or withholding under subsection (a) shall be required in the case of amounts of per diem for subsistence paid by the United States Government (directly or by contract) to any nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954, as amended.

(d) *Alien resident of Puerto Rico.* For purposes of this section, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

[Sec. 1441 as amended by sec. 544(f), Mutual Security Act 1954 (added by sec. 11(a), Mutual Security Act 1956 (70 Stat. 568)); sec. 40(b), Technical Amendments Act 1958 (72 Stat. 1638). (Sec. 544(f), Mutual Security Act 1954, was repealed by sec. 11(b)(1), Mutual Security Act 1957 (71 Stat. 365), with the proviso that sec. 1441 was not affected by the repeal.)]

§ 1.1441–1 Requirement for withholding of tax on nonresident aliens and foreign corporations.

Except as otherwise provided in §§ 1.1441–3 and 1.1441–4, withholding of a tax of 30 percent is required in the case of the items of income specified in § 1.1441–2 (to the extent that such items constitute gross income from sources within the United States) paid to a nonresident alien individual, a nonresident partnership composed in whole or in part of nonresident alien individuals, or a nonresident foreign corporation. The rate of 30 percent shall be reduced as may be provided by treaty with any country. See section 894, relating to income exempt under treaty. For purposes of this section, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

§ 1.1441–2 Income subject to withholding.

(a) *Fixed or determinable annual or periodical income.* (1) The gross amount of fixed or determinable annual or periodical income is subject to withholding. Section 1441 specifically includes in such income interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments; but other kinds of income are included, as, for instance, royalties. The term "fixed or determinable annual or periodical" income is merely descriptive of the character of a class of income. If an item of income falls within the class of income contemplated by the statute, it is immaterial whether payment of that item is made in a series of repeated payments or in a single lump sum. Thus, $5,000 in royalty income would come within the meaning

of the term, whether paid in 10 payments of $500 each or in one payment of $5,000.

(2) Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. The fact that a payment is not made annually or periodically does not, however, necessarily prevent its being fixed or determinable annual or periodical income. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable periodical income. The share of the fixed or determinable annual or periodical income of an estate or trust from sources within the United States which is required to be distributed currently, or which has been paid or credited during the taxable year, to a nonresident alien beneficiary of such estate or trust constitutes fixed or determinable annual or periodical income. Such items as taxes, interest on mortgages, or premiums on insurance paid to or for the account of a nonresident alien landlord by a tenant, pursuant to the terms of the lease, constitute fixed or determinable annual or periodical income.

(3) Income derived from the sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income. However, the consideration received from the transfer of property is fixed or determinable annual or periodical income if for purposes of the income tax the consideration is treated as rentals or royalties and not as the proceeds of a sale of property.

(b) *Amounts considered to be gains from the sale or exchange of capital assets.* Withholding is also required on the gross amount of the items described in section 402(a)(2), relating to treatment of total distributions from certain employees' trusts; in section 631 (b) and (c), relating to treatment of gain on disposal of timber or coal with a retained economic interest; in section 1235, relating to treatment of gain on sale or exchange of patents; and after September 2, 1958, in section 403(a)(2), relating to treatment of payments under certain employee annuities, each of which items is considered to be gain from the sale or exchange of capital assets.

§ 1.1441–3 Exceptions and rules of special application.

(a) *Income from sources without the United States.* To the extent that items of income constitute gross income from sources without the United States, they are not subject to withholding under § 1.1441–1. For rules governing the determination of the sources of income, see part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(b) *Corporate distributions*—(1) *Nontaxable portion.* The tax shall be withheld at the source under § 1.1441–1 on the gross amount of any distribution made by a corporation other than—

(i) A nontaxable distribution payable in stock or stock rights, and

(ii) A distribution which is treated as a distribution in part or full payment in exchange for stock.

This rule shall apply without regard to any claim that all or a portion of the distribution is not taxable under section 871 or 881. The tax shall be withheld on the gross amount of the distribution even though the payee may be entitled to the benefits of section 34, relating to the credit for dividends received by individuals, or section 116, relating to partial exclusion of dividends received by individuals. Appropriate adjustment, if any, will be made upon the payee's filing of a claim for refund, together with appropriate supporting evidence, in accordance with paragraph (h) of this section.

(2) *Dividends paid by a foreign corporation.* No withholding under § 1.1441–1 is required in the case of dividends paid by a foreign corporation unless (i) the corporation is engaged in trade or business within the United States, and (ii) more than 85 percent of the gross income of the corporation for the 3-year period ending with the close of its taxable year preceding the declaration of the dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

(3) *Dividends paid by a China Trade Act corporation.* Withholding is required under § 1.1441–1 on dividends paid by a corporation organized under the China Trade Act of 1922 (15 U. S. C., c. 4) if the dividends are treated as income from sources within the United States under part I (section 861 and following), subchapter N, chapter 1 of the Code, and are distributed to—

(i) A nonresident alien other than a resident of Formosa or Hong Kong at the time of the distribution, or

(ii) A nonresident partnership composed in whole or in part of nonresident aliens (other than a partnership resident in Formosa or Hong Kong), or

(iii) A nonresident foreign corporation (other than a corporation resident in Formosa or Hong Kong).

(4) *Dividends paid to shareholder whose status is not definite.* When a payer corporation or any other person, including a nominee, having the control, receipt, custody, disposal, or payment of dividends has no definite knowledge of the status of a shareholder, the tax shall be withheld under § 1.1441–1 if the shareholder's address is outside the United States. If the shareholder's address is within the United States, it may be assumed for the purpose of withholding on dividends that the shareholder is a citizen or resident of the United States. Unless the name and style of the shareholder are such as to indicate clearly that he is a nonresident alien, an address in care of another person in the United States does not of itself warrant treating the shareholder as a nonresident alien for such purpose. If a shareholder changes his address from a place without the United States to a place within the United States, the tax shall be withheld on dividends unless proof is furnished showing that he is a citizen or resident of the United States. For general provisions for claiming United States citizenship or residence, see § 1.1441–5.

(c) *Interest*—(1) *Government obligations.* Withholding is required under § 1.1441–1 in the case of interest paid on obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. See section 103 and the regulations thereunder, relating to the taxation of such interest, and § 1.1461–1, relating to ownership certificates.

(2) *Assumed obligations.* If, in connection with the sale of a corporation's property, payment of the bonds or other obligations of the corporation is assumed by the assignee, the assignee, whether an individual, partnership, or corporation, shall deduct and withhold such taxes under § 1.1441–1 as would be required to be withheld by the assignor had no such sale or transfer been made.

(3) *Defaulted interest coupons.* The tax shall be withheld at the source under § 1.1441–1 on the gross amount of interest without regard to whether or not the payment constitutes a return of capital or the payment of income within the meaning of section 61. Thus, for example, the tax shall be withheld in accordance with § 1.1441–1 from defaulted interest payments upon bonds which were purchased flat at quotations representing the price of both the bonds and the defaulted matured interest coupons. Appropriate adjustment, if any, will be made upon the payee's filing of a claim for refund, together with appropriate supporting evidence, in accordance with paragraph (h) of this section.

(4) *Unknown owner.* Withholding is required under § 1.1441–1 in the case of interest upon all bonds or securities the owners of which are not known to the withholding agent unless such bonds or securities were issued by a corporation before January 1, 1934, contain a tax-free covenant, and do not have a maturity date which was extended on or after that date. For withholding under section 1451 in the case of unknown owners, see paragraph (a) (2) of § 1.1451–1.

(5) *Tax-free covenant bonds*—(i) *Issued on or after January 1, 1934.* Withholding is required under § 1.1441–1 in the case of interest upon bonds or other corporate obligations issued on or after January 1, 1934, and containing a tax-free covenant.

(ii) *Issued before January 1, 1934.* Withholding is not required under §1.-1441–1 in the case of interest upon bonds or other corporate obligations issued before January 1, 1934, containing a tax-free covenant, and not having a maturity date which was extended on or after that

date. A domestic or resident fiduciary is required, however, to withhold tax under § 1.1441–1 in the case of so much of such interest as is properly allocable under section 652 or 662 to a nonresident alien beneficiary. See paragraph (f) of this section and of § 1.1451–1. For general rules respecting the withholding of tax under section 1451 in the case of such interest, see § 1.1451–1.

(iii) *Extended maturity date.* Withholding is required under § 1.1441–1 in the case of interest upon bonds or other corporate obligations issued before January 1, 1934, and containing a tax-free covenant, if the maturity date of the bonds or obligations has been extended on or after that date. See paragraph (c) of § 1.1451–1.

(iv) *Special rate of 27½ percent.* The rate of tax to be withheld at the source under § 1.1441–1 shall not exceed 27½ percent in the case of interest on bonds, mortgages, or deeds of trust, or other similar obligations of a corporation if—

(*a*) The liability assumed by the debtor exceeds 27½ percent of the interest, and

(*b*) The interest would be subject to withholding under the provisions of subsections (a), (b), and (c) of section 1451 except for the fact that the maturity date of the obligations has been extended on or after January 1, 1934. See paragraph (c) of § 1.1451–1.

(d) *Amounts considered to be gains from the sale or exchange of capital assets.* (1) If, in the case of the amounts enumerated in paragraph (b) of § 1.1441–2 which are considered to be gains from the sale or exchange of capital assets, the withholding agent does not know the amount of recognized gain, he is required to deduct and withhold such amount under § 1.1441–1 as may be necessary to assure that the tax withheld will not be less than 30 percent of the recognized gain. For this purpose the recognized gain shall be determined without regard to the deduction allowed by section 1202 in respect of capital gains. The amount so withheld shall not exceed 30 percent of the gross proceeds from the transaction giving rise to the recognized gain, except that the gross proceeds may be determined by excluding the net unrealized appreciation described in section 402 (a) (2). Appropriate adjustment, if any, will be made upon the payee's filing of a claim for refund, together with appropriate supporting evidence, in accordance with paragraph (h) of this section.

(2) The withholding agent may rely upon the written statement of the person entitled to the income described in this paragraph as to the amount of gain recognized on the transaction involved. This statement shall show the computation of the gain and shall be furnished to the withholding agent in duplicate. The duplicate copy of the statement shall be forwarded with a letter of transmittal to the District Director of Internal Revenue, Baltimore 2, Maryland; except that on and after January 1, 1957, such copy shall be forwarded to the Director of International Operations, Internal Revenue Service, Washington 25, D.C.

(e) *Personal exemption.* (1) The taxation of nonresident alien individuals is provided for in part II (section 871 and following), subchapter N, chapter 1 of the Code. Section 874(a) makes the filing of a return a prerequisite to the allowance of deductions, including deductions of personal exemptions. Except in the circumstances described in subparagraph (2) of this paragraph, personal exemptions do not serve to reduce the amount of tax to be withheld under § 1.1441–1.

(2) In the determination of the tax to be withheld at the source under § 1.1441–1 from remuneration paid for labor or personal services performed within the United States by a nonresident alien, the benefit of the deduction for one personal exemption provided in section 151 shall be allowed, prorated upon a daily basis for the period of employment during any portion of which labor or personal services are performed within the United States by the alien. The proration is on the basis of $1.70 per day. Thus, if A, a nonresident alien seaman employed by X Shipping Corporation, is paid in 1955 upon the termination of a voyage covering 100 days and A performs personal services within the United States during, or incident to, the voyage, the amount of $170 will be allocated as the portion of the deduction to be allowed against the remuneration for personal services performed within the United States during that voyage; and withholding at 30 percent shall be applied against the balance, if any, of the remuneration. If, for example, the total remuneration paid to A for that voyage is $2,000, of which the amount of $800 is allocable to sources within the United States, a tax in the amount of $189 is required to be withheld under § 1.1441–1. As to what constitutes remuneration for labor or personal services performed within the United States, see section 861 (a) (3) and the regulations thereunder.

(f) *Fiduciaries.* Resident or domestic fiduciaries are required to withhold the tax at source under § 1.1441–1 on all items of income specified in § 1.1441–2 of nonresident alien beneficiaries, to the extent that such items constitute gross income from sources within the United States. Such income paid to a nonresident alien fiduciary is subject to withholding under § 1.1441–1 even though the beneficiaries of the estate or trust are citizens or residents of the United States.

(g) *Trust income taxable to grantor.* The income of a trust created by a nonresident alien individual and taxable to the grantor under the provisions of subpart E, part I, subchapter J, chapter 1 of the Code, is subject to withholding under § 1.1441–1, even though the fiduciary or beneficiaries of the trust are citizens or residents of the United States and regardless of whether the beneficiaries are exempt from income tax.

(h) *Claims for refund.* Notwithstanding § 301.6402–2 of this chapter (Regulations on Procedure and Administration), any claim for refund referred to in paragraphs (b), (c), and (d) of this section which is filed on and after January 1, 1957, shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C. For special rules permitting the use of the income tax return as a claim for refund, see § 301.6402–3 of this chapter (Regulations on Procedure and Administration).

(i) *Rents paid to foreign tax-exempt organizations.* For the rule for withholding on rents paid to foreign tax-exempt organizations, see § 1.1443–1.

§ 1.1441–4 Exemptions from withholding.

(a) *Interest*—(1) *Interest on bank deposits.* Interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States is not subject to withholding under § 1.1441–1.

(2) *Sale of bonds between interest dates.* The tax is not required to be withheld under § 1.1441–1 on accrued interest paid by the buyer in connection with the sale of bonds between interest dates, even though the interest is subject to tax under section 871 or 881. The exemption from withholding granted by this subparagraph is not a determination that the accrued interest is not fixed or determinable annual or periodical income.

(b) *Compensation for personal services*—(1) *Exemption under section 1441.* The salary or other compensation for personal services of a nonresident alien individual who enters and leaves the United States at frequent intervals shall not be subject to withholding of tax under § 1.1441–1 if—

(i) The nonresident alien is a resident of Canada or Mexico, or

(ii) The nonresident alien is engaged in agricultural labor as defined in section 3121 (g) and the regulations thereunder.

(2) *Withholding of tax under section 3402.* For collection of the income tax at source under section 3402 upon remuneration paid for services performed by a nonresident alien individual who is a resident of Canada or Mexico and who enters and leaves the United States at frequent intervals, see section 3401 (a) (7) and the regulations thereunder.

(3) *Proration of personal exemption.* For provisions allowing the benefit of the deduction for the personal exemption on a prorated basis, see paragraph (e) of § 1.1441–3.

(c) *Dividends paid by China Trade Act corporations.* Withholding is not required under § 1.1441–1 upon dividends distributed by a corporation organized under the China Trade Act of 1922 (15 U.S.C., ch. 4) to or for the benefit of a resident of Formosa or Hong Kong and which are exempt from taxation by section 943.

(d) *Inhabitants of Virgin Islands*—(1) *Allowance of exemption.* No withholding is required under § 1.1441–1 upon any item of income paid to any person who at the time of payment reasonably expects to satisfy his income tax obligations with respect to that item under section 28 (a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642). That section provides that all persons whose permanent residence is in the Virgin Islands "shall satisfy their income

tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the Treasury of the Virgin Islands." For the purpose of this paragraph, the term "person" shall include an individual, partnership, and corporation.

(2) *Claiming exemption.* To avoid withholding of tax at source under § 1.1441–1, the payee of the income shall notify the withholding agent by letter in duplicate that he expects to satisfy his income tax obligations under section 28 (a) of the Revised Organic Act of the Virgin Islands with respect to all income to be paid to him by the withholding agent during the current calendar year. This letter of notification shall constitute authorization to the payer of the income to pay income to the payee during that year without deduction of the tax at source under § 1.1441–1.

(3) *Disposition of letter.* The duplicate copy of each letter of notification shall be forwarded with a letter of transmittal to the District Director of Internal Revenue, Baltimore 2, Maryland; except that on and after January 1, 1957, such copy shall be forwarded to the Director of International Operations, Internal Revenue Service, Washington 25, D.C.

(e) *Per diem of certain alien trainees.* Effective with respect to payments made on and after July 18, 1956, withholding is not required under section 1441 (a) or § 1.1441–1 in the case of amounts of per diem for subsistence paid by the United States Government (directly or by contract) to any nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954, as amended (22 U. S. C. ch. 24). This rule shall apply even though such amounts are subject to tax under section 871.

§ 1.1441–5 Claiming United States citizenship or residence.

(a) *Individuals.* For purposes of chapter 3 of the Code, an individual's written statement that he is a citizen or resident of the United States may be relied upon by the payer of the income as proof that such individual is a citizen or resident of the United States. This statement shall be furnished to the withholding agent in duplicate. An alien may claim residence in the United States by filing Form 1078 with the withholding agent in duplicate in lieu of the above statement.

(b) *Partnerships and corporations.* For purposes of chapter 3 of the Code a written statement from a partnership or corporation claiming residence in the United States may be relied upon by the payer of the income as proof that such partnership or corporation is a resident of the United States. This statement shall be furnished to the withholding agent in duplicate. It shall contain the address of the taxpayer's office or place of business in the United States and shall be signed by a member of the partnership or by an officer of the corporation. The official title of the corporate officer shall also be given.

(c) *Disposition of statement and form.* The duplicate copy of each statement and form filed pursuant to this section shall be forwarded with a letter of transmittal to the Director of International Operations, Internal Revenue Service, Washington 25, D.C.

(d) *Definitions.* As to who are nonresident alien individuals, see sections 871, 7701, and the regulations thereunder. As to what partnerships and corporations are deemed to be nonresident, see sections 881, 882, 7701, and the regulations thereunder.

(e) *Effective date.* This section shall apply with respect to payments made after December 31, 1956. The provisions of 26 CFR (1939), 39.143–3(a) and 39.144–2 (Regulations 118) corresponding to the provisions of this section, which were made applicable to chapter 3 of the Code by Treasury Decision 6091 (19 F.R. 5167, C.B. 1954–2, 47), shall be deemed to apply under such chapter with respect to all payments made after December 31, 1954, and before January 1, 1957. Nothing in this section shall be construed, however, to require the renewal of a statement of citizenship or residence, or of a Form 1078, which was filed in accordance with prior regulations in effect at the time of the filing, if such statement or form has been actively and continuously used, since such time, as a basis for determining the United States citizenship or residence of the payee involved.

§ 1.1442 Statutory provisions; withholding of tax on foreign corporations.

SEC. 1442. *Withholding of tax on foreign corporations.* In the case of foreign corporations subject to taxation under this subtitle not engaged in trade or business within the United States, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 or section 1451 a tax equal to 30 percent thereof; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein.

§ 1.1442–1 Withholding of tax on foreign corporations.

For regulations respecting the withholding of tax at source under section 1442 in the case of nonresident foreign corporations, see §§ 1.1441–1 and 1.1451–1.

§ 1.1443 Statutory provisions; foreign tax-exempt organizations.

SEC. 1443. *Foreign tax-exempt organizations.* In the case of income of a foreign organization subject to the tax imposed by section 511, this chapter shall apply to rents includible under section 512 in computing its unrelated business taxable income, but only to the extent and subject to such conditions as may be provided under regulations prescribed by the Secretary or his delegate.

§ 1.1443–1 Rents paid to foreign tax-exempt organizations.

The gross amount of rents paid to a foreign organization subject to the tax imposed by section 511, which are includible under section 512 in computing its unrelated business taxable income, is subject to withholding of a tax of 30 percent in the manner prescribed for withholding of the tax under § 1.1441–1, even though the organization is engaged in trade or business within the United States.

TAX-FREE COVENANT BONDS

§ 1.1451 Statutory provisions; tax-free covenant bonds.

SEC. 1451. *Tax-free covenant bonds*—(a) *Requirement of withholding.* In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, issued before January 1, 1934, contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this subtitle on the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 percent (regardless of whether the liability assumed by the obligor is less than, equal to, or greater than 2 percent) of the interest on such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods, if payable to—

(1) An individual,

(2) A partnership, or

(3) A foreign corporation not engaged in trade or business within the United States.

(b) *Payments to foreigners.* Notwithstanding subsection (a), if the liability assumed by the obligor does not exceed 2 percent of the interest, then the deduction and withholding shall be at the rate of 30 percent in the case of—

(1) A nonresident alien individual,

(2) Any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, and

(3) A foreign corporation not engaged in trade or business within the United States.

(c) *Owner unknown.* If the owners of such obligations are not known to the withholding agent, the Secretary or his delegate may authorize such deduction and withholding to be at the rate of 2 percent, or, if the liability assumed by the obligor does not exceed 2 percent of the interest, then at the rate of 30 percent.

(d) *Benefit of personal exemptions.* Deduction and withholding under this section shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the deduction for personal exemptions provided in section 151; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Secretary or his delegate under section 874.

(e) *Alien residents of Puerto Rico.* For purposes of this section, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

(f) *Income of obligor and obligee.* The obligor shall not be allowed a deduction for the payment of the tax imposed by this subtitle, or any other tax paid pursuant to the tax-free covenant clause, nor shall such tax be included in the gross income of the obligee.

§ 1.1451–1 Tax-free covenant bonds issued before January 1, 1934.

(a) *Rates of withholding*—(1) *Rate of 2 percent.* Withholding of a tax equal to 2 percent is required in the case of interest upon bonds or other corporate obligations containing a tax-free covenant and issued before January 1, 1934, paid to an individual, a fiduciary, or a partnership, whether resident or nonresident, or to a nonresident foreign corporation, regardless of whether the liability assumed by the obligor is less than, equal to, or greater than 2 percent.

(2) *Rate of 30 percent.* Notwithstanding subparagraph (1) of this paragraph, if the liability assumed by the obligor does not exceed 2 percent of the interest, withholding is required at the rate of 30 percent in the case of payments to a nonresident alien individual, a nonresident partnership composed in whole or in part of nonresident aliens, a nonresident foreign corporation, or an owner who is unknown to the withholding agent.

(3) *Obligations of resident payers.* The rates of withholding specified in subparagraphs (1) and (2) of this paragraph are applicable to interest on such tax-free covenant bonds issued by a domestic corporation or by a resident foreign corporation.

(4) *Obligations of nonresident payers.* A nonresident foreign corporation having a fiscal or paying agent in the United States is required to withhold a tax of 2 percent in the case of interest upon its tax-free covenant bonds issued before January 1, 1934, which is paid to an individual or fiduciary who is a citizen or resident of the United States, to a partnership any member of which is a citizen or resident, or to an unknown owner.

(5) *Interest from sources without the United States.* Withholding is not required under section 1451 in the case of interest upon bonds or other corporate obligations issued before January 1, 1934, and containing a tax-free covenant if the interest is not to be treated as income from sources within the United States and the payments are made to a nonresident alien, a partnership composed wholly of nonresident aliens, or a nonresident foreign corporation.

(6) *Tax treaties.* The rates of tax to be withheld in accordance with this paragraph shall be reduced as may be provided by treaty with any country. See section 894, relating to income exempt under treaty.

(b) *Date of issue.* The withholding provisions of section 1451 are applicable only to bonds, mortgages, or deeds of trust, or other similar obligations of a corporation which were issued before January 1, 1934, and which contain a tax-free covenant. For the purpose of section 1451, bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, are issued when delivered. If a broker or other person acts as selling agent of the obligor, the obligation is issued when delivered by the agent to the purchaser. If a broker or other person purchases the obligation outright for the purpose of holding or reselling it, the obligation is issued when delivered to such broker or other person.

(c) *Extended maturity date.* In cases where on or after January 1, 1934, the maturity date of bonds or other obligations of a corporation is extended, the bonds or other obligations shall be considered to have been issued on or after January 1, 1934. The interest on such obligations is not subject to the withholding provisions of section 1451 but falls within the class of interest described in section 1441. See paragraph (c) (5) (iii) of § 1.1441–3.

(d) *Covenant in trust deed.* Bonds issued under a trust deed containing a tax-free covenant are treated as if they contain such a covenant. If neither the bonds nor the trust deeds given by the obligor to secure them contained a tax-free covenant, but the original trust deeds were modified before January 1, 1934, by supplemental agreements containing a tax-free covenant executed by the obligor corporation and the trustee, the bonds issued before January 1, 1934, are subject to the provisions of section 1451, provided appropriate authority existed for the modification of the trust deeds in this manner. The authority must have been contained in the original trust deeds or actually secured from the bondholders.

(e) *Notation showing date of issue.* In order that the date of issue of bonds, mortgages, deeds of trust, or other similar corporate obligations containing a tax-free covenant may be readily determined by the owner for the purpose of preparing the ownership certificates required by § 1.1461–1, the issuing or debtor corporation shall indicate the date of issue by an appropriate notation, or use the phrase "issued on or after January 1, 1934," on each such obligation or in a statement accompanying the delivery of the obligation.

(f) *Effect of withholding on income taxes of bondholder and issuing corporation*—(1) *Federal tax.* In the case of corporate bonds or other corporate obligations issued before January 1, 1934, and containing a tax-free covenant, the corporation paying a Federal tax, or any part of it, for someone else pursuant to its agreement is not entitled to deduct such payment from its gross income on any ground; nor shall the tax so paid be included in the gross income of the bondholder. The amount of the tax so paid may, nevertheless, be claimed by the bondholder in accordance with paragraph (a) of § 1.1462–1 as a credit against the total amount of income tax due. See also section 32. The tax so paid by the corporation upon tax-free covenant bond interest payable to a domestic or resident fiduciary and allocable to any nonresident alien beneficiary under section 652 or 662 is allowable, pro rata, as a credit against—

(i) The tax required to be withheld by the fiduciary in accordance with paragraph (f) of § 1.1441–3 from the income of the beneficiary, and

(ii) The total income tax computed in the return of the beneficiary, as indicated in paragraph (a) of § 1.1462–1.

(2) *State taxes.* In the case of corporate bonds or other obligations containing an appropriate tax-free covenant, the corporation paying for someone else, pursuant to its agreement, a State tax or any tax other than a Federal tax may deduct such payment as interest paid on indebtedness.

(g) *Alien resident of Puerto Rico.* For purposes of this section the term "nonresident alien individual" includes an alien resident of Puerto Rico.

(h) *Other rules for withholding of tax under section 1451.* The rules for withholding stated in paragraphs (c) (2) and (3), (f), and (g) of § 1.1441–3 shall also apply for purposes of withholding the tax under this section.

§ 1.1451–2 Exemptions from withholding under section 1451.

(a) *Claiming personal exemptions.* Withholding under § 1.1451–1 from interest on bonds or other obligations of corporations issued before January 1, 1934, and containing a tax-free covenant shall not be required if there is filed with the withholding agent when presenting coupons for payment, or not later than February 1 of the following year, an ownership certificate on Form 1000 stating—

(1) In the case of a citizen or resident of the United States, that his taxable income does not exceed his deductions for personal exemptions allowed under section 151; or

(2) In the case of an estate or trust the fiduciary of which is a citizen or resident of the United States, that its taxable income does not exceed the deduction for the personal exemption allowed under section 642 (b).

(b) *Claiming residence in United States.* To claim residence in the United States for purposes of section 1451, see § 1.1441–5.

(c) *Other exemptions.* The exemptions allowed by paragraphs (a) (2) and (d) of § 1.1441–4 shall also apply for purposes of section 1451.

APPLICATION OF WITHHOLDING PROVISIONS

§ 1.1461 Statutory provisions; return and payment of withheld tax.

SEC. 1461. *Return and payment of withheld tax.* Every person required to deduct and withhold any tax under this chapter shall, on or before March 15, of each year, make return thereof and pay the tax to the officer designated in section 6151. Every such person is hereby made liable for such tax and is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this chapter.

§ 1.1461–1 Ownership certificates for bond interest.

(a) *Citizens and residents of the United States.* In accordance with section 6041, citizens, resident individuals, fiduciaries, and partnerships, and nonresident partnerships all of the members of which are citizens or residents, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal or paying agent in the United States, shall, when presenting interest coupons for payment, file ownership certificates for each issue of such obligations issued before January 1, 1934, and containing a tax-free covenant. This rule shall apply without regard to the amount of the interest coupons.

(b) *Nonresident aliens and foreign corporations.* (1) In accordance with section 6041, nonresident alien individuals, nonresident partnerships composed in whole or in part of nonresident aliens, nonresident foreign corporations, and unknown owners, owning bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, shall, when presenting interest coupons for payment,

file ownership certificates for each issue of all such obligations whether or not the obligation contains a tax-free covenant. This rule shall apply without regard to the amount of the interest coupons and without regard to the date on which the obligations were issued.

(2) Ownership certificates are not required to be filed, however, by a nonresident alien individual, a partnership composed wholly of nonresident aliens, or a nonresident foreign corporation in connection with interest payments on bonds, mortgages, or deeds of trust, or other similar obligations of a nonresident foreign corporation or of any domestic or foreign corporation which qualifies under section 861 (a) (1) (B) (relating to interest from payers deriving substantially all their income from sources without the United States).

(3) Ownership certificates shall also be filed in the case of interest paid on obligations of the United States or of any agency or instrumentality thereof, irrespective of the date on which the obligations are issued or of the amount of the interest, if the obligations are owned by a nonresident alien individual, nonresident partnership composed in whole or in part of nonresident aliens, nonresident foreign corporation, or an unknown owner.

(c) *Overdue coupon bonds.* In the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted, ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.

(d) *Information shown on ownership certificate.* The ownership certificate shall show the name and address of the obligor, the name and address of the owner of the obligations, a description of the obligations, the amount of interest and its due date, the rate at which tax is to be withheld, and the date upon which the interest coupons were presented for payment. In the case of ownership certificates filed with the withholding agent on and after January 1, 1957, the certificate shall also show the amount of tax if any withheld; or, if the certificate has been used under a tax treaty regulation to claim a release of tax withheld, then it shall show both the amount of tax withheld and also the amount of tax released. On and after January 1, 1957, this paragraph shall apply to all special variations of Form 1001 referred to in paragraph (i) of this section.

(e) *Ownership certificates not required.* Ownership certificates are not required to be filed in the case of interest payments on—

(1) Obligations of a State, Territory, or possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;

(2) Bonds, mortgages, or deeds of trust, or other similar obligations issued by an individual or a partnership; and

(3) Obligations owned by a domestic corporation, resident foreign corporation, or foreign government.

(f) *Interest coupons unaccompanied by ownership certificates.* (1) When interest coupons detached from corporate bonds, or from obligations of the United States or of any agency or instrumentality thereof, are received unaccompanied by ownership certificates, the first bank to which the coupons are presented for payment shall require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee and alleging that the owner of the bonds is unknown to the payee. This rule shall not apply if the owner of the bonds is known to the bank and the bank is satisfied that the owner is a person who is not required to file an ownership certificate.

(2) The bank shall also require the payee to prepare an ownership certificate on Form 1001, which shall be modified by crossing out "owner," inserting "payee," stamping or writing across the face of the certificate "Statement furnished," and adding the name of the bank.

(3) The statement furnished pursuant to this paragraph shall be forwarded to the District Director of Internal Revenue, Baltimore 2, Maryland, with the quarterly return on Form 1012; except that on and after January 1, 1957, such statement shall be forwarded to the Director of International Operations, Internal Revenue Service, Washington 25, D.C., with the annual return on Form 1042.

(g) *Noncoupon bonds*—(1) *General rule.* Ownership certificates on Form 1000 or Form 1001 are required in connection with interest payments on noncoupon bonds as in the case of coupon bonds. If an ownership certificate is not furnished by the owner of a noncoupon bond, the certificate shall be prepared by the withholding agent but is not required to be signed by the owner.

(2) *Application of tax treaties.* Ownership certificates are not required, however, when claiming the benefit of an exemption from tax, or reduced rate of tax, granted by an applicable tax convention in respect of interest payments on noncoupon bonds. Regulations under the various income tax conventions require, in lieu of an ownership certificate, the use of an exemption (or reduced rate) certificate (or corresponding letter) in the case of such interest payments. Such a certificate may not be prepared by the withholding agent but must be signed by the owner of the interest, or by his trustee or agent, in accordance with the applicable tax treaty regulation.

(h) *Form of ownership certificate for citizens and residents.* Form 1000 shall be used in preparing ownership certificates of individuals or fiduciaries who are citizens or residents of the United States, of resident partnerships, and of nonresident partnerships all of the members of which are citizens or residents. If the obligations are issued by a nonresident foreign corporation having a fiscal or paying agent in the United States, Form 1000 shall be modified to show the name and address of the fiscal agent or the paying agent in addition to the name and address of the debtor corporation. Duplicate copies of Form 1000 are not required.

(i) *Form of ownership certificate for nonresident aliens and foreign corporations.* Form 1001 shall be used in preparing ownership certificates of nonresident alien individuals, nonresident partnerships composed in whole or in part of nonresident aliens, nonresident foreign corporations, and unknown owners. A special variation of Form 1001 (designated by a letter or letters following the number 1001) shall be used, however, in preparing ownership certificates of persons claiming the benefit of an exemption from tax, or reduced rate of tax, granted by an applicable income tax convention in respect of interest payments on coupon bonds. See the applicable tax treaty regulation and paragraph (d) of this section. In the case of payments of interest made before January 1, 1957, duplicate copies of Form 1001 are not required; on and after that date Form 1001 shall be filed in duplicate whenever the form is required by this section. The special variations of Form 1001 shall be filed in duplicate, as required by the applicable tax treaty regulation.

(j) *Ownership certificates in the case of fiduciaries and joint owners.* (1) Fiduciaries having the control and custody of more than one estate or trust, the assets of which include bonds of corporations and other securities, shall execute a certificate of ownership for each estate or trust even though the bonds are of the same issue. The ownership certificate shall show both the name of the estate or trust and the name and address of the fiduciary.

(2) Separate ownership certificates shall be executed in behalf of each person owning bonds jointly with another.

(k) *Inconsistent regulations.* All regulations inconsistent with the provisions of this section shall be deemed to have been modified accordingly.

§ 1.1461–2 Return and payment of tax withheld on and after January 1, 1957.

(a) *Effective date.* This section shall apply only with respect to payments of income made on and after January 1, 1957. For provisions relating to payments made before that date, see § 1.1461–3.

(b) *Form 1042*—(1) *Filing requirement.* Every withholding agent shall make on or before March 15 an annual return on Form 1042 of the tax withheld under chapter 3 of the Code upon all the items of income to which that chapter applies. Form 1042 shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C. The return shall be prepared in duplicate and shall show in summary form the tax required to be withheld under chapter 3 during the previous calendar year and to be shown on Forms 1000, 1001, 1042S, and on all special variations of Form 1001 referred to in paragraph (i) if § 1.1461–1. The duplicate copy of Form 1042 shall be retained by the withholding agent.

(2) *Summary of accompanying forms.* Form 1042 shall be accompanied by the original copies of all Forms 1000 and by

the original and duplicate copies of all Forms 1001, 1042S, and all special variations of Form 1001 referred to in paragraph (i) of § 1.1461–1, which were filed with, or prepared by, the withholding agent during the previous calendar year, including such forms upon which income exempt from withholding of tax is reported. The various forms so forwarded with Form 1042 are not required to be listed thereon; but they shall be summarized on Form 1042 by showing in the manner prescribed thereon and in the instructions applicable thereto, the total number of each form submitted and, with respect to that particular form, the gross amount of income paid and the rates of tax applicable thereto, the total amount of income paid which was exempt from withholding of tax, the amount of tax withheld at the various applicable rates, and the amount of tax withheld but released or refunded by the withholding agent. The information so given with respect to Form 1042S shall be arranged on a per-country basis as to payees with addresses in the various foreign countries which have entered into an income tax convention with the United States and on a combined basis as to payees with addresses in all other countries. This per-country arrangement is not required in the case of the other forms forwarded with Form 1042. The exemption and reduced rate certificates, such as Form 1001A–D or Form 1001A–J, referred to in paragraph (g) (2) of § 1.1461–1 are not required to accompany, or to be summarized on, Form 1042.

(3) *Manner of preparing ownership certificates.* To facilitate compliance with subparagraph (2) of this paragraph the ownership certificates (Form 1000, Form 1001, and all special variations of Form 1001 referred to in paragraph (i) of § 1.1461–1) prepared by any withholding agent for forwarding with Form 1042 shall be prepared and arranged in accordance with the instructions applicable thereto and consistently with the manner prescribed by paragraph (c) (3) (ii) of this section with respect to Form 1042S.

(4) *Modification of Form 1042.* If Form 1000 is modified in accordance with paragraph (h) of § 1.1461–1 to show the name and address of a fiscal or paying agent in the United States, Form 1042 shall be likewise modified.

(c) *Form 1042S*—(1) *Filing requirement.* Every withholding agent shall make on or before March 15 an annual information return on Form 1042S of all items of income specified in § 1.1441–2 (to the extent that such items constitute gross income from sources within the United States) paid during the previous calendar year to nonresident alien individuals, nonresident partnerships composed in whole or in part of nonresident alien individuals, and nonresident foreign corporations, including such items of income upon which, under the authority of any Treasury regulation or ruling of the Commissioner, no withholding of tax is required under chapter 3 or in respect of which the tax, though required to be withheld under such chapter, has, pursuant to such authority, been released or refunded to the payee. Income paid to such persons and required to be shown on Form W–2, Form 1001, or on any special variation of Form 1001 referred to in paragraph (i) of § 1.1461–1, or the substitute thereof, is not, however, required to be shown on Form 1042S. The original and duplicate copies of Form 1042S shall accompany Form 1042 and shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C.

(2) *Information to be furnished.* (i) Form 1042S shall show the name and address of the payee of the income, of the withholding agent, of the agent for the withholding agent, and of the payer of the income if the payer is not the same as the withholding agent. It shall also show the nature of the item of income paid, the gross amount of the item, and, if withholding upon that item is required under chapter 3 of the Code, the rate of tax applicable thereto and the amount of tax withheld. If any part of the tax required to be withheld has been released or refunded to the payee, Form 1042S shall show the amount of tax so released or refunded.

(ii) If a Form 1042S is prepared in respect of an item of income upon which tax has not been withheld under chapter 3 of the Code, a brief statement as to the authority for such failure to withhold shall be made upon the form itself. If necessary, however, a separate statement as to such authority may be attached to the original copy of the Form 1042S.

(iii) If a Form 1042S is prepared in respect of compensation from which the personal exemption is deducted in accordance with paragraph (e) of § 1.1441–3, the amount of the compensation allocable to labor or personal services performed within the United States, together with the amount of the deduction for the prorated personal exemption, shall be shown on a separate statement attached to the original copy of that form.

(3) *Manner of preparing Form 1042S.* (i) Form 1042S shall be prepared in quadruplicate with respect to each separate payment of any item of income made during the calendar year, except that, at the option of the withholding agent, one form may be used to show the total amount of any item paid during the calendar year to the same payee. Items different in kind may not be combined on one Form 1042S. Thus, if three dividends on the same stock are paid to the same payee during the calendar year, the three payments may be entered on three separate Forms 1042S or in total amount on one Form 1042S. On the other hand, a payment of interest, dividends, and rents may not be shown on the same Form 1042S. Payment of an item of income to a nominee or representative for the benefit of other persons in respect of whom Forms 1042S are required may not be shown on a single Form 1042S but must be identified with the ultimate recipients of the income if such information is known to the payer of the income.

(ii) The Forms 1042S prepared by any withholding agent for forwarding with Form 1042 shall be segregated as to payees with addresses in foreign countries which have entered into an income tax convention with the United States and as to payees with addresses in all other countries. The first such group shall be arranged alphabetically both as to the name of the payee and the name of the foreign country in which the payee has an address; the second such group shall be arranged alphabetically as to the name of the payee only. Separate adding machine tapes shall then be prepared for each such foreign country which has entered into an income tax convention with the United States, showing as to that country the number of such forms submitted, the total amount of income paid which was exempt from withholding of tax, and, as to each separate applicable rate of tax, the gross amount of income paid and the amount of tax withheld. Another adding machine tape showing the same information shall then be prepared with respect to the combined number of all other countries. These adding machine tapes shall be properly identified with the respective groups of forms to which they apply, and the totals thereon used as a basis for making the summary on Form 1042 prescribed by paragraph (b) (2) of this section. If circumstances warrant, the withholding agent may use any other appropriate method, in lieu of adding machine tapes, for presenting the information required by this subdivision.

(iii) The triplicate copy of Form 1042S shall be furnished to the payee indicated thereon, and the quadruplicate shall be retained by the withholding agent.

(4) *Alternative methods.* To the extent that the withholding agent's system of record keeping makes impractical the use of Form 1042S in the manner prescribed by subparagraph (3) of this paragraph, he may devise and submit for the prior approval of the Commissioner a variation of Form 1042S which will include the information required by subparagraph (2) of this paragraph and which will substantially comply with the requirements of subparagraph (3) of this paragraph. Request for such approval shall be accompanied by an explanation as to why such variation is necessary.

(d) *Information to be furnished by Commissioner.* If a foreign country has entered into an income tax convention with the United States which provides for the mutual exchange of information, the Commissioner shall, as soon as practicable after the close of a calendar year during which the convention is in effect, transmit to the appropriate authority designated in the convention with that country the following forms which have been filed pursuant to this section for that year, namely, all duplicate copies of Forms 1001 and 1042S showing a payee with an address in that country and all duplicate copies of the special variation of Form 1001 referred to in paragraph (i) of § 1.1461–1 which is applicable to that country. These forms are not to be furnished to any such foreign country, however, if the Commissioner ascertains

through appropriate channels that the forms are not required by that country.

(e) *Date of payment; penalties.* The tax required to be returned on Form 1042 shall be paid to the Director of International Operations, Internal Revenue Service, Washington 25, D.C., on or before March 15 of the following year. For penalties and additions to the tax attaching upon failure to make returns or such payments, see sections 6651, 6653, 7202, and 7203.

(f) *Special items.* The tax withheld in accordance with paragraphs (b) (1), (c) (3), and (d) (1) of § 1.1441–3 shall be returned and paid in accordance with this section even though the items involved may not constitute gross income in whole or in part. For such purpose, a reference in this section to an item or amount of income shall, where appropriate, be deemed to refer also to the items specified in such paragraphs or the amount thereof.

(g) *Inconsistent regulations.* All regulations inconsistent with the provisions of this section shall be deemed to have been modified accordingly.

§ 1.1461–3 Return and payment of tax withheld before January 1, 1957.

(a) *Effective date.* This section shall apply only with respect to payments of income made before January 1, 1957. For provisions relating to payments made on and after that date, see § 1.1461–2.

(b) *Interest on certain bonds—(1) Form 1013.* Every withholding agent shall make on or before March 15 an annual return on Form 1013 of the tax withheld under chapter 3 of the Code from interest (other than interest on noncoupon bonds with respect to which a reduced rate certificate (or corresponding letter) has been filed with the withholding agent in accordance with regulations under a tax convention) on (i) bonds or other obligations of corporations and (ii) obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. This return shall be filed with the District Director of Internal Revenue, Baltimore 2, Maryland; except that on and after January 1, 1957, such return shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C.

(2) *Form 1012.* The withholding agent also shall make and file with the District Director of Internal Revenue, Baltimore 2, Maryland, a quarterly return on Form 1012 of the tax so withheld from such interest, on or before the last day of the month following the termination of the quarter for which the return is made. On and after January 1, 1957, however, the quarterly return on Form 1012 shall be made and filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C. The ownership certificates (Form 1000, Form 1001, and all special variations of Form 1001 referred to in paragraph (i) of § 1.1461–1) shall be forwarded with the quarterly return, even though the interest in respect of which the certificate is filed is exempt from withholding of tax. Forms 1001 shall be listed on the quarterly return. All special variations of Form 1001 (referred to in paragraph (i) of § 1.1461–1) which have been used to secure a reduction in the rate of tax withheld at source shall also be listed on the quarterly return. While Forms 1000 need not be listed on the return, the number of such forms submitted, the total amount of interest paid, and the total amount of the tax required to be withheld in respect of such forms shall be entered in the spaces provided on Form 1012.

(3) *Modification of Forms 1012 and 1013.* If Form 1000 is modified in accordance with paragraph (h) of § 1.1461–1 to show the name and address of a fiscal or paying agent in the United States, Forms 1012 and 1013 shall be likewise modified.

(c) *Payments other than interest on certain bonds—(1) Form 1042.* Every withholding agent shall make on or before March 15 an annual return on Form 1042 of the tax withheld under chapter 3 of the Code from income other than bond interest in respect of which the tax is required to be reported on Form 1012. This return shall be filed with the District Director of Internal Revenue, Baltimore 2, Maryland; except that on and after January 1, 1957, such return shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C. The return shall show the amount of tax required to be withheld from each nonresident alien, nonresident partnership composed in whole or in part of nonresident aliens, and nonresident foreign corporation, to which income other than such bond interest was paid during the previous calendar year.

(2) *Income exempt from tax.* The withholding agent shall also report on Form 1042—

(i) All such items of income, otherwise required to be returned thereon pursuant to subparagraph (1) of this paragraph, upon which the tax has not been withheld at source because of an income tax convention which is in effect between the United States and a foreign country, and

(ii) Interest paid to such persons on noncoupon bonds with respect to which an exemption certificate (or corresponding letter) has been filed with the withholding agent in accordance with regulations under a tax convention.

(3) *Proration of personal exemption.* In a case where the personal exemption is prorated in accordance with paragraph (e) of § 1.1441–3 the amount of the compensation allocable to labor or personal services performed within the United States, together with the amount of the deduction for the prorated personal exemption, shall be shown on a separate statement attached to the annual return on Form 1042.

(d) *Date of payment; penalties.* The tax required to be returned on Forms 1012, 1013, and 1042 shall be paid to the district director on or before March 15 of the following year; except that on and after January 1, 1957, such tax shall be paid to the Director of International Operations, Internal Revenue Service, Washington 25, D.C. For penalties and additions to the tax attaching upon failure to make returns or such payments, see sections 6651, 6653, 7202, and 7203.

(e) *Information returns.* For the extent to which ownership certificates and returns filed by withholding agents will constitute, and be treated as, returns of information required by section 6041, see the regulations issued pursuant to that section.

(f) *Special items.* The tax withheld in accordance with paragraphs (b) (1), (c) (3), and (d) (1) of § 1.1441–3 shall be returned and paid in accordance with this section even though the items involved may not constitute gross income in whole or in part. For such purpose, a reference in this section to an item or amount of income shall, where appropriate, be deemed to refer also to the items specified in such paragraphs or the amount thereof.

§ 1.1462 Statutory provisions; withheld tax as credit to recipient of income.

SEC. 1462. *Withheld tax as credit to recipient of income.* Income on which any tax is required to be withheld at the source under this chapter shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

§ 1.1462–1 Withheld tax as credit to recipient of income.

(a) *Return of income from which tax was withheld.* The entire amount of the income from which the tax is required to be withheld shall be included in gross income in the return required to be made by the recipient of the income, without deduction for the amount required to be withheld, but the tax so withheld shall be allowed as a credit against the total income tax computed in the taxpayer's return.

(b) *Amounts paid to fiduciaries.* Tax withheld at the source under chapter 3 of the Code upon income paid to any fiduciary is deemed to have been paid by the taxpayer ultimately liable for the tax upon such income. Thus, for example, if any taxpayer is subject to the taxes imposed by section 1, 2, 3, or 11 upon any portion of the income of a nonresident alien estate or trust, the part of any tax withheld at the source which is properly allocable to the income so taxed to such taxpayer shall be credited against the amount of the income tax computed upon his return, and any excess shall be credited against any income, war profits, or excess profits tax, or installment thereof, then due from the taxpayer, and any balance shall be refunded.

§ 1.1463 Statutory provisions; tax paid by recipient of income.

SEC. 1463. *Tax paid by recipient of income.* If any tax required under this chapter to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed on or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

§ 1.1463–1 Tax paid by recipient of income.

If the tax required to be withheld under chapter 3 of the Code is paid by the recipient of the income or by the withholding agent, it shall not be recollected from the other, regardless of the original liability therefor; and, in such event, no penalty will be asserted against either person for failure to return or pay the tax where no fraud or purpose to evade payment is involved.

§ 1.1464 Statutory provisions; refunds and credits with respect to withheld tax.

SEC. 1464. *Refunds and credits with respect to withheld tax.* Where there has been an overpayment of tax under this chapter, any refund or credit made under chapter 65 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent.

§ 1.1464–1 Refunds and credits.

The refund or credit under chapter 65 of the Code of an overpayment of tax which has actually been withheld at the source under chapter 3 of the Code shall be made to the taxpayer from whose income the amount of such tax was in fact withheld. To the extent that the overpayment under chapter 3 was not in fact withheld at the source, but was paid, by the withholding agent the refund or credit under chapter 65 of the overpayment shall be made to the withholding agent. Thus, where a debtor corporation assumes liability pursuant to its tax-free covenant for the tax required to be withheld under chapter 3 upon interest and pays the tax in behalf of its bondholder, and it can be shown that the bondholder is not in fact liable for any tax, the overpayment of tax shall be credited or refunded to the withholding agent in accordance with chapter 65 since the tax was not actually deducted and withheld from the interest paid to the bondholder. In further illustration, where a withholding agent who is required by chapter 3 to withhold $300 tax from rents paid to a nonresident alien individual mistakenly withholds $320 and mistakenly pays $350 as internal revenue tax, the amount of $30 shall be credited or refunded to the withholding agent in accordance with chapter 65 and the amount of $20 shall be credited or refunded in accordance with such chapter to the person from whose income such amount has been withheld.

§ 1.1465 Statutory provisions; definition of withholding agent.

SEC. 1465. *Definition of withholding agent.* The term "withholding agent" means any person required to deduct and withhold any tax under this chapter.

§ 1.1465–1 General provisions relating to withholding agents.

(a) *Withholding agents in case of United States obligations.* In the case of interest on obligations of the United States or of any agency or instrumentality thereof the withholding agents shall be—

(1) The Commissioner of the Public Debt, for interest paid by checks issued through the Bureau of the Public Debt;

(2) The Treasurer of the United States, for all interest paid by him, whether by check or otherwise; and

(3) Each Federal Reserve bank, for all interest paid by it, whether by check or otherwise.

(b) *Person designated to act for withholding agent.* (1) A debtor corporation having an issue of bonds or other similar obligations which appoints a duly authorized agent to act on its behalf under the withholding provisions of chapter 3 of the Code is required to file a notice of such appointment with the District Director of Internal Revenue, Baltimore 2, Maryland, giving the name and address of the agent; except that on and after January 1, 1957, such notice shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C.

(2) If the person designated by a debtor corporation to act for it as withholding agent has not withheld any tax from the income nor received any funds from the debtor corporation to pay the tax which the debtor corporation assumed in connection with its tax-free covenant bonds, then that person cannot be held liable for the tax assumed by the debtor corporation merely by reason of the designee's appointment as withholding agent.

(3) If a duly authorized withholding agent has become insolvent or for any other reason fails to make payment under section 1461 of money deposited with it by the debtor corporation to pay taxes, or of money withheld from bondholders, the debtor corporation is not discharged of its liability under chapter 3 of the Code since the withholding agent is merely the agent of the debtor corporation.

(c) *Payments other than money.* In any case where income is payable in any medium other than money the withholding agent shall not release the property so received until the property has been converted into funds sufficient to enable the withholding agent to pay over in money the tax required to be withheld under chapter 3 of the Code with respect to such income.

Rules Applicable to Recovery of Excessive Profits on Government Contracts

RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS

§ 1.1471 Statutory provisions; recovery of excessive profits on government contracts.

SEC. 1471. *Recovery of excessive profits on government contracts*—(a) *Method of collection.* If the amount of profit required to be paid into the Treasury under section 3 of the Act of March 27, 1934, as amended (34 U. S. C. 496), with respect to contracts completed within taxable years subject to this code is not voluntarily paid, the Secretary or his delegate shall collect the same under the methods employed to collect taxes under this subtitle.

(b) *Laws applicable.* All provisions of law (including penalties) applicable with respect to the taxes imposed by this subtitle and not inconsistent with section 3 of the Act of March 27, 1934, as amended, shall apply with respect to the assessment, collection, or payment of excess profits to the Treasury as provided by subsection (a), and to refunds by the Treasury of overpayments of excess profits into the Treasury.

§ 1.1471–1 Recovery of excessive profits on government contracts.

The inclusion of the statutory provisions of section 1471 in this part does not supersede the provisions of 26 CFR (1939) Part 17 (Treasury Decision 4906) and 26 CFR (1939) Part 16 (Treasury Decision 4909) as made applicable to section 1471 by Treasury Decision 6091 (19 F.R. 5167, C.B. 1954–2, 47).

MITIGATION OF EFFECT OF RENEGOTIATION OF GOVERNMENT CONTRACTS

§ 1.1481 Statutory provisions; mitigation of effect of renegotiation of government contracts.

SEC. 1481. *Mitigation of effect of renegotiation of government contracts*—(a) *Reduction for prior taxable year*—(1) *Excessive profits eliminated for prior taxable year.* In the case of a contract with the United States or any agency thereof, or any subcontract thereunder, which is made by the taxpayer, if a renegotiation is made in respect of such contract or subcontract and an amount of excessive profits received or accrued under such contract or subcontract for a taxable year (referred to in this section as "prior taxable year") is eliminated and, the taxpayer is required to pay or repay to the United States or any agency thereof the amount of excessive profits eliminated or the amount of excessive profits eliminated is applied as an offset against other amounts due the taxpayer, the part of the contract or subcontract price which was received or was accrued for the prior taxable year shall be reduced by the amount of excessive profits eliminated. For purposes of this section—

(A) The term "renegotiation" includes any transaction which is a renegotiation within the meaning of the Federal renegotiation act applicable to such transaction, any modification of one or more contracts with the United States or any agency thereof, and any agreement with the United States or any agency thereof in respect of one or more such contracts or subcontracts thereunder.

(B) The term "excessive profits" includes any amount which constitutes excessive profits within the meaning assigned to such term by the applicable Federal renegotiation act, any part of the contract price of a contract with the United States or any agency thereof, any part of the subcontract price of a subcontract under such a contract, and any profits derived from one or more such contracts or subcontracts.

(C) The term "subcontract" includes any purchase order or agreement which is a subcontract within the meaning assigned to such term by the applicable Federal renegotiation act.

(D) The term "Federal renegotiation act" includes section 403 of the Sixth Supplemental National Defense Appropriation Act (Public Law 528, 77th Cong., 2d Sess.), as amended or supplemented, the Renegotiation Act of 1948, as amended or supplemented, and the Renegotiation Act of 1951, as amended or supplemented.

(2) *Reduction of reimbursement for prior taxable year.* In the case of a cost-plus-a-fixed-fee contract between the United States or any agency thereof and the taxpayer, if an item for which the taxpayer has been reimbursed is disallowed as an item of cost chargeable to such contract and the taxpayer is required to repay the United States or any agency thereof the amount disallowed or the amount disallowed is applied as an offset against other amounts due the taxpayer, the amount of the reimbursement of the taxpayer under the contract for the taxable year in which the reimbursement for such item was received or was accrued shall be reduced by the amount disallowed.

(3) *Deduction disallowed.* The amount of the payment, repayment, or offset described in paragraph (1) or paragraph (2) shall not constitute a deduction for the year in which paid or incurred.

(4) *Exception.* The foregoing provisions of this subsection shall not apply in respect of any contract if the taxpayer shows to the satisfaction of the Secretary or his delegate that a different method of accounting for the amount of the payment, repayment, or disallowance clearly reflects income, and in such case the payment, repayment, or disallowance shall be accounted for with respect to the taxable year provided for under such method, which for the purposes of subsections (b) and (c) shall be considered a prior taxable year.

(b) *Credit against repayment on account of renegotiation or allowance*—(1) *General rule.* There shall be credited against the amount of excessive profits eliminated the amount by which the tax for the prior taxable year under this subtitle is decreased by reason of the application of paragraph (1) of subsection (a); and there shall be credited against the amount disallowed the amount by which the tax for the prior taxable year under this subtitle is decreased by reason of the application of paragraph (2) of subsection (a).

(2) *Credit for barred year.* If at the time of the payment, repayment, or offset described in paragraph (1) or paragraph (2) of subsection (a), refund or credit of tax under this subtitle for the prior taxable year is prevented (except for the provisions of section 1311) by any provision of the internal revenue laws other than section 7122, or by rule of law, the amount by which the tax for such year under this subtitle is decreased by the application of paragraph (1) or paragraph (2) of subsection (a) shall be computed under this paragraph. There shall first be ascertained the tax previously determined for the prior taxable year. The amount of the tax previously determined shall be the excess of—

(A) The sum of—

(i) The amount shown as the tax by the taxpayer on his return (determined as provided in section 6211 (b) (1) and (3)), if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(ii) The amounts previously assessed (or collected without assessment) as a deficiency, over—

(B) The amount of rebates, as defined in section 6211 (b) (2), made.

There shall then be ascertained the decrease in tax previously determined which results solely from the application of paragraph (1) or paragraph (2) of subsection (a) to the prior taxable year. The amount so ascertained, together with any amounts collected as additions to the tax or interest, as a result of paragraph (1) or paragraph (2) of subsection (a) not having been applied to the prior taxable year, shall be the amount by which such tax is decreased.

(3) *Interest.* In determining the amount of the credit under this subsection no interest shall be allowed with respect to the amount ascertained under paragraph (1); except that if interest is charged by the United States or the agency thereof on account of the disallowance for any period before the date of the payment, repayment, or offset, the credit shall be increased by an amount equal to interest on the amount ascertained under such paragraph at the same rate and for the period (prior to the date of the payment, repayment, or offset) as interest is so charged.

(c) *Credit in lieu of other credit or refund.* If a credit is allowed under subsection (b) with respect to a prior taxable year no other credit or refund under the internal-revenue laws founded on the application of subsection (a) shall be made on account of the amount allowed with respect to such taxable year. If the amount allowable as a credit under subsection (b) exceeds the amount allowed under such subsection, the excess shall, for purposes of the internal revenue laws relating to credit or refund of tax, be treated as an overpayment for the prior taxable year which was made at the time the payment, repayment, or offset was made.

(d) *Renegotiation of government contracts affecting taxable years prior to 1954.* If a recovery of excessive profits through renegotiation as described in this section relates to profits of a taxable year subject to the Internal Revenue Code of 1939, the adjustments in respect of such renegotiation shall be made under section 3806 of such code.

§ 1.1481–1 [Reserved]

Tax on Transfers To Avoid Income Tax

§ 1.1491 Statutory provisions; imposition of tax.

SEC. 1491. *Imposition of tax.* There is hereby imposed on the transfer of stock or securities by a citizen or resident of the United States, or by a domestic corporation or partnership, or by a trust which is not a foreign trust, to a foreign corporation as paid-in surplus or as a contribution to capital, or to a foreign trust, or to a foreign partnership, an excise tax equal to 27½ percent of the excess of—

(1) The value of the stock or securities so transferred, over

(2) Its adjusted basis (for determining gain) in the hands of the transferor.

§ 1.1491–1 Imposition of tax.

Section 1491 imposes an excise tax upon transfers of stock or securities by a citizen or resident of the United States, or by a domestic corporation or partnership, or by a trust which is not a foreign trust, to a foreign corporation as paid-in surplus or as a contribution to capital, or to a foreign trust, or to a foreign partnership. The tax is in an amount equal to 27½ percent of the excess of (a) the value of the stock or securities so transferred over (b) its adjusted basis, as provided in section 1011, for determining gain in the hands of the transferor.

§ 1.1492 Statutory provisions; nontaxable transfers.

SEC. 1492. *Nontaxable transfers.* The tax imposed by section 1491 shall not apply—

(1) If the transferee is an organization exempt from income tax under part I of Subchapter F of Chapter I (other than an organization described in section 401 (a)); or

(2) If before the transfer it has been established to the satisfaction of the Secretary or his delegate that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

§ 1.1492–1 Nontaxable transfers.

(a) The tax imposed by section 1491 does not apply:

(1) If the transferee is an organization (other than an organization described in section 401 (a)) exempt from income tax under the provisions of sections 501 to 504, inclusive; or

(2) If before the transfer it has been established to the satisfaction of the Commissioner that the transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

(b) Whether a transfer of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes is a question to be determined from the facts and circumstances of each particular case. In any such case where a transferor desires to establish that the transfer is not in pursuance of such a plan, a statement of the facts relating to the plan under which the transfer is to be made or was made, together with a copy of the plan if in writing, shall be forwarded to the Commissioner of Internal Revenue, Washington 25, D. C., for a ruling. This statement shall contain, or be verified by, a written declaration that it is made under the penalties of perjury. A letter notifying the transferor of the Commissioner's determination will be mailed to the transferor.

§ 1.1493 Statutory provisions: definition of foreign trust.

SEC. 1493. *Definition of foreign trust.* A trust shall be considered a foreign trust within the meaning of this chapter if, assuming a subsequent sale by the trustee, outside the United States and for cash, of the property so transferred, the profit, if any, from such sale would not be included in the gross income of the trust under this subtitle.

§ 1.1493–1 Definition of foreign trust.

(a) A trust is to be considered a "foreign trust" within the meaning of chapter 5 of the Code if, assuming a subsequent sale by the trustee, outside the United States and for cash, of the property transferred to the trust, the profit, if any, from such sale (being income from sources without the United States under the provisions of part I (section 861 and following), subchapter N, chapter 1 of the Code), would not be included in the gross income of the trust under subtitle A of the Code.

(b) A domestic corporation or partnership is one organized or created in the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, or under the law of the United States or of any State or Territory; and a foreign corporation or partnership is one which is not domestic.

§ 1.1494 Statutory provisions; payment and collection.

SEC. 1494. *Payment and collection*—(a) *Time for payment.* The tax imposed by section 1491 shall, without assessment or notice and demand, be due and payable by the transferor at the time of the transfer, and shall be assessed, collected, and paid under regulations prescribed by the Secretary or his delegate.

(b) *Abatement or refund.* Under regulations prescribed by the Secretary or his delegate, the tax may be abated, remitted, or refunded if after the transfer it has been established to the satisfaction of the Secretary or his delegate that such transfer was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

§ 1.1494–1 Returns; payment and collection of tax.

(a) *Returns and payment.* Every person making a transfer described in section 1491 shall make a return to the district director on the day on which the transfer is made and, unless the transfer is nontaxable under section

1492, pay the tax due on such transfer. This return, which shall contain, or be verified by, a written declaration that it is made under the penalties of perjury, shall be made on Form 926 and shall be filed with the district director to whom the transferor's return of income is required to be made. The return shall set forth in detail the following information:

(1) Name and address of transferor, and place of organization or creation, if a corporation, partnership, or trust.

(2) Name and address of transferee, place of organization or creation, and whether the transferee is a foreign corporation, a foreign trust, or a foreign partnership. If the transferee is a foreign trust or a foreign partnership, the name and address of the fiduciary and each beneficiary, in the case of a trust, or of each partner, in the case of a partnership, must be shown.

(3) Description and amount of stock or securities transferred, the date of transfer, and a complete statement showing all the facts relating to the transfer, accompanied by a copy of the plan under which the transfer was made.

(4) The fair market value of the stock or securities transferred as of the date of transfer, and the adjusted basis provided in section 1011 for determining gain in the hands of the transferor.

(5) Whether the transfer was made in pursuance of a plan submitted to and approved by the Commissioner as not having as one of its principal purposes the avoidance of Federal income taxes. If the plan has been so approved, a copy of the Commissioner's letter approving the plan shall accompany the return.

(6) Such other information as may be required by the return form.

(b) *Certificate.* (1) If the transferee of the stock or securities, the transfer of which is reported in the return, is a foreign organization meeting the tests of exemption from income tax provided in part I (section 501 and following), subchapter F, chapter 1 of the Code, and the transferor on that account claims that no liability for tax is imposed by section 1491, such transferor must file with Form 926 a certificate establishing the exemption of the transferee under such part I. This certificate, which shall contain, or be verified by, a written declaration that it is made under the penalties of perjury, shall contain complete information showing the character of the transferee, the purpose for which it was organized, its actual activities, the source of its income and the disposition of such income, whether or not any of its income is credited to surplus or may inure to the benefit of any private shareholder or individual, and in general all facts relating to its operations which affect its right to exemption. To such certificate shall be attached a copy of the charter or articles of incorporation, the by-laws of the organization, and the latest financial statement showing the assets, liabilities, receipts, and disbursements of the organization.

(2) If the transferee is a foreign organization which has been held to be exempt from income tax under such part I (or corresponding provisions of prior law), a copy of the Commissioner's letter so holding shall be filed with Form 926 in lieu of the above certificate and attachments.

(c) *Assessment and collection.* The determination, assessment, and collection of the tax and the examination of returns and claims filed pursuant to chapter 5 of the Code will be made under such procedure as may be prescribed from time to time by the Commissioner.

§ 1.1494–2 Effective date.

Chapter 5 (section 1491 and following) of the Internal Revenue Code of 1954 and the regulations prescribed thereunder apply with respect to transfers occurring after December 31, 1954. (See section 7851(a)(1)(B).) Chapter 7 (section 1250 and following) of the Internal Revenue Code of 1939 and the regulations applicable thereto apply with respect to transfers occurring prior to January 1, 1955.

Consolidated Returns

RETURNS AND PAYMENT OF TAX

§ 1.1501 Statutory provisions; privilege to file consolidated returns.

SEC. 1501. *Privilege to file consolidated returns.* An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

§ 1.1501–1 Privilege to file consolidated returns.

For regulations relating to the privilege of filing consolidated returns, see § 1.1502–0 and following. For convenience, the several sections of the regulations under section 1502 have to the extent practicable, been given numbers corresponding, respectively, to the section numbers of prior consolidated returns regulations but preceded by the code number 1.1502.

§ 1.1502 Statutory provisions; regulations.

SEC. 1502. *Regulations.* The Secretary or his delegate shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

§ 1.1502–0 Introductory.

The regulations prescribed under section 1502 of the Internal Revenue Code of 1954 are applicable in the case of all corporations (with certain statutory exceptions) to taxable years beginning after December 31, 1953, and ending after August 16, 1954, and with respect to such taxable years, the regulations under section 1502 supersede 26 CFR (1939) part 24 (Regulations 129). Any provision of the regulations under such section, the applicability of which is stated in terms of a specific date (occurring after December 31, 1953) or in terms of taxable years ending after a specific date (occurring after December 31, 1953), shall apply to taxable years ending after such specific date. Each such provision shall in the case of a taxable year subject to 26 CFR (1939) part 24 (Regulations 129), be deemed included in 26 CFR (1939) part 24 (Regulations 129) but shall be applicable only to taxable years ending after such specific date. The provisions of 26 CFR (1939) part 24 (Regulations 129), superseded by provisions of the regulations under section 1502, the applicability of which is stated in terms of a specific date (occurring after December 31, 1953) shall be deemed to be included in the regulations under such section but shall be applicable only to the period prior to the taking effect of the corresponding provision of the regulations under such section.

§ 1.1502–1 Privilege of making consolidated returns.

(a) Section 1501 gives to the corporations of an affiliated group the privilege of making a consolidated income tax return for the taxable year in lieu of separate returns. This privilege is given, however, upon the condition that all corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to the regulations under section 1502 applicable to such taxable year and any amendments thereof duly prescribed prior to the last day prescribed by law for the filing of the return; and the making of the consolidated return is considered as such consent.

(b) With respect to a taxable year to which 26 CFR (1939) Part 24 (Regulations 129), as amended by the regulations under section 1502 is applicable, the regulations to which consent is made are those in 26 CFR (1939) Part 24 (Regulations 129), as amended, and as further amended by the regulations under such section. With respect to a taxable year to which the regulations under section 1502 are applicable, the regulations to which consent is made are the regulations under such section as changed to the extent that portions of 26 CFR (1939) Part 24 (Regulations 129) are applicable. For example, in the case of a fiscal year ending October 31, 1954, the Internal Revenue Code of 1939 and 26 CFR (1939) Part 24 (Regulations 129) are applicable to a consolidated return filed for such year. In such case, if the first distribution in pursuance of a plan of complete liquidation of a member of the affiliated group occurs on or after June 22, 1954, § 1.1502–38 is applicable in lieu of 26 CFR (1939) 24.38 (Regulations 129). On the other hand, if such a

distribution occurs before June 22, 1954, 26 CFR (1939) 24.38 (Regulations 129) is applicable. Similarly, in the case of a return filed for the calendar year 1954, the Internal Revenue Code of 1954 and the regulations under section 1502 are applicable. In such case, if the first distribution in pursuance of a plan of complete liquidation of a member of the affiliated group occurs prior to June 22, 1954, 26 CFR (1939) 24.38 (Regulations 129) is applicable in lieu of § 1.1502–38. If such distribution occurs on or after June 22, 1954, § 1.1502–38 is applicable.

(c) The last day prescribed by law for the filing of the return includes the last day of the period of any extension of time granted by the Commissioner.

(d) The tax liability of the members of the affiliated group for the taxable year involved will be determined in accordance with the provisions of the regulations to which consent is given and without regard to any changes of the rules therein prescribed made subsequent to the last day prescribed by law for the filing of the return for such year.

§ 1.1502–2 Definitions.

(a) *Code.* The term "Code" means the Internal Revenue Code of 1954 and the sections of statutory law referred to in the regulations under section 1502 unless otherwise stated, are sections of that Code.

(b) *Affiliated group.* (1) The term "affiliated group" is defined in section 1504 and includes the common parent corporation and every other corporation for the period during which such corporation is a member of the affiliated group within the meaning of such section. It does not include any corporation which is not an "includible corporation" as defined by section 1504 (b). An includible corporation is defined by such section to mean any corporation, except—

(i) A corporation exempt under section 501 from the taxes imposed by subtitle A of the Code;

(ii) An insurance company subject to taxation under section 802 or 821 (except as provided in section 1504 (c));

(iii) A foreign corporation (except as provided in section 1504 (d));

(iv) A corporation entitled to the benefits of section 931 by reason of receiving a large percentage of its income from sources within possessions of the United States;

(v) A corporation organized under the China Trade Act of 1922 (15 U.S.C. ch. 4);

(vi) A regulated investment company subject to tax under subchapter M, chapter 1 of the Code;

(vii) An unincorporated business enterprise subject to tax as a corporation under section 1361; and

(viii) For periods before September 24, 1959, an electing small business corporation as defined in section 1371(b).

The consolidated income tax return must include every includible corporation which, under the provisions of section 1504, is a member of the affiliated group. No corporation which is connected by stock ownership with an affiliated group of includible corporations through a nonincludible corporation may be included in the consolidated return of such group. In no case may a consolidated return be filed by subsidiary corporations as an affiliated group unless the common parent corporation through which the subsidiaries are connected is a member of the group. For instance, there will not be recognized as an affiliated group two domestic industrial corporations, the common parent corporation of which is a regulated investment company subject to tax under subchapter M, chapter 1 of the Code.

(2) An insurance company subject to tax under section 831 is an includible corporation and may be included in an affiliated group, together with corporations other than insurance companies taxable under section 802 or 821. Insurance companies subject to tax under section 802 or 821 are not includible corporations under section 1504 (b). Under section 1504 (c), however, a domestic insurance company taxable under section 802 may be included in an affiliated group comprised solely of other domestic insurance companies taxable under section 802; it may not be included in an affiliated group with other corporations. An affiliated group of domestic insurance companies taxable under section 802 may not include a domestic insurance company taxable under section 821 or 831.

(3) In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of Canada or of Mexico and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for income tax purposes as a domestic corporation. The option to treat such foreign corporation as a domestic corporation so that it may be included in a consolidated return must be exercised at the time of making the consolidated return, and cannot be exercised at any time thereafter. If the election is exercised to treat such foreign corporation as a domestic corporation, it must be included in the consolidated return of the affiliated group of which it is a member for each consecutive year thereafter for which such group makes or is required to make a consolidated return.

(4) An affiliated group of corporations, within the meaning of section 1504, is formed at the time that the common parent corporation, which is an includible corporation, becomes the owner directly of stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends) of another includible corporation; a corporation becomes a member of such an affiliated group at the time that one or more members of such group become the owners directly of stock possessing at least 80 percent of the voting power of all classes of its stock and at least 80 percent of each class of its nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends); and a corporation ceases to be a member of such an affiliated group at the time that the members of such group cease to own directly stock possessing at least 80 percent of the voting power of all classes of its stock, or at least 80 percent of each class of its nonvoting stock (not including nonvoting stock which is limited and preferred as to dividends).

(c) *Consolidated return period.* The term "consolidated return period" means the taxable year 1929, or any subsequent taxable year, for which a consolidated return is made or is required, income tax return, excess profits tax return, or both, including the period during which a subsidiary corporation is engaged in distributing its assets in liquidation.

(d) *Subsidiary.* The term "subsidiary" means a corporation (other than the common parent corporation) which is a member of the affiliated group during any part of the consolidated return period.

(e) *Tax.* The term "tax" means any tax imposed by chapter 1 of the Code, and includes any interest, penalty, additional amount, or addition to the tax, payable in respect thereof.

(f) *Terms defined in Internal Revenue Code.* Terms which are defined in the Code shall, when used in the regulations under section 1502 have the meaning assigned to them by the Code, unless specifically otherwise defined.

(g) *Regulated public utility.* (1) The term "regulated public utility" means a corporation described in section 1503 (c). It includes a corporation (i) whose operations are an integral part of the furnishing or sale of a product or service described in such section by an interconnected and coordinated public utility system or systems and (ii) whose rates for furnishing products or services to the system or systems are established or approved by a regulatory body described in section 1503 (c) (1). For the purpose of determining whether or not 80 percent of the gross income of the corporation is from the furnishing or sale of such product or service, income received in consideration for the product or service described shall include only income received directly therefrom and income from the furnishing or sale of byproducts and residual products which are directly necessary and incidental to the furnishing of such product or service. In determining under subdivision (i) of this subparagraph whether the operations of a particular corporation constitute an integral part of the "furnishing or sale" of a product or service described in section 1503 (c), the income of a corporation shall be deemed to be from such source only to the extent that it is in consideration for necessary processing of either the product described in section 1503 (c) or the essential facilities used in making available to customers such product or service.

§ 1.1502–3 Applicability of other provisions of law.

Any matter in the determination of which the provisions of the regulations

under section 1502 are not applicable shall be determined in accordance with the provisions of the Code or other law applicable thereto.

§§ 1.1502–4 to 1.1502–9 [Reserved]

§ 1.1502–10 Exercise of privilege.

(a) *When privilege must be exercised.* The privilege of making a consolidated return under section 1502 for any taxable year of an affiliated group must be exercised at the time of making the return of the common parent corporation for such year. For this purpose, the return is considered as made on the due date of such return (including any extensions of time granted by the Commissioner), regardless of the actual previous date of filing. Under no circumstances can such privilege be exercised at any time thereafter. The filing of separate returns for a taxable year does not constitute an election binding upon the corporation in subsequent years. If the privilege is exercised at the time of making the return, separate returns cannot thereafter be made for such year. (See, however, § 1.1502–18, relating to failure to comply with the regulations under section 1502.)

(b) *Effect of tentative returns.* In no case will the privilege under paragraph (a) of this section be considered as exercised at the time of making a so-called "tentative return" (made, for example, in order to obtain an extension of time for making the return required by law). However, if any such tentative return is made upon the basis of a consolidated return or a separate return, the return required by law must be made upon the same basis, unless upon the making of the return required by law (either a separate return or a consolidated return, as the case may be) the payments theretofore made and to be made are adjusted in a manner satisfactory to the Commissioner.

(c) *Estimated tax.* (1). Except as provided in subparagraph (2) of this paragraph, the provisions of section 6016 (relating to declarations of estimated tax by corporations) and section 6154 (relating to payments of estimated tax by corporations) shall be applicable to the several members of an affiliated group in the same manner and to the same extent as in the case of corporations filing separate returns, whether or not such affiliated group files a consolidated return. The declaration of estimated tax shall be filed and payments shall be made to the district director for the internal revenue district prescribed for the filing of a separate income tax return in the case of each member of the group required to file a declaration of estimated tax. If a consolidated return is filed, the amounts of any payments made with respect to the consolidated return period shall be credited against the tax liability of the affiliated group with respect to the consolidated return period.

(2) If the affiliated group intends to file a consolidated return for the taxable year, the common parent corporation may file a declaration of estimated tax for the group. In such case, all of the several members of the affiliated group shall be treated for the purpose of applying the provisions of sections 6016 and 6154 as a single corporation. Where such a declaration is filed, each subsidiary shall notify the district director for the internal revenue district prescribed for the filing of a separate income tax return by such subsidiary that its estimate is included in the declaration made by the common parent corporation. If the affiliated group does not file a consolidated return for the year for which such a declaration is filed, the payments made with respect to such declaration shall be apportioned among the several members of the group in the manner designated by the common parent corporation for the purpose of determining any addition to the tax provided by section 6655.

(3) In any case in which an affiliated group has made payments with respect to a declaration made on a group basis and such group does not file a consolidated return for the taxable year, the payments made thereon shall be applied against the tax liability of the members of the group in a manner satisfactory to the Commissioner.

(4) See § 1.1502–15 (relating to liability for tax) and § 1.1502–49 (relating to additions to tax for failure to pay estimated tax).

§ 1.1502–11 Consolidated returns for subsequent years.

(a) *Consolidated returns required for subsequent years.* If a consolidated return is made under section 1502 for any taxable year, a consolidated return must be made for each subsequent taxable year during which the affiliated group remains in existence unless (1) a corporation (other than a corporation created or organized, directly or indirectly, by a member of the group) has become a member of the group during such subsequent taxable year, or (2) subsequent to the exercise of the election to make consolidated returns, subtitle A of the Code to the extent applicable to corporations, or the regulations under section 1502 which have been consented to, have been amended and any such amendment is of a character which makes substantially less advantageous to affiliated groups as a class the continued filing of consolidated returns, regardless of the effective date of such amendment, or (3) the Commissioner, prior to the time of making the return, upon application made by the common parent corporation and for good cause shown, grants permission to change. For the purpose of subparagraph (2) of this paragraph, the expiration of a provision shall be considered as an amendment to the Code made on the date of such expiration.

(b) *Effect of separate returns when consolidated return is required.* If the making of a consolidated return is required for any taxable year, the tax liability of the members of the affiliated group shall be computed in the same manner as if a consolidated return had been made, even though separate returns are made; amounts assessed upon the basis of separate returns shall be considered as having been assessed upon the basis of a consolidated return; and amounts paid upon the basis of separate returns shall be considered as having been paid by the common parent corporation. In such cases the making of separate returns shall not be considered as the making of a return for the purpose of computing any period of limitation or any deficiency. If a consolidated return for such taxable year is thereafter made, such return shall, for the purpose of computing periods of limitation and any deficiency, be considered as the return for such year.

(c) *When affiliated group remains in existence.* For the purpose of the regulations under section 1502, an affiliated group shall be considered as remaining in existence if the common parent corporation remains as a common parent and at least one subsidiary remains affiliated with it, whether or not such subsidiary was a member of the group at the time the group was formed and whether or not one or more corporations have become subsidiaries or have ceased to be subsidiaries at any time after the group was formed.

(d) *When affiliated group terminates.* For the purpose of the regulations under section 1502, an affiliated group shall be considered as terminated if the common parent corporation ceases to be the common parent or if there is no subsidiary affiliated with it.

§ 1.1502–12 Making consolidated return and filing other forms.

(a) *Consolidated return made by common parent corporation.* A consolidated return shall be made on Form 1120 by the common parent corporation for the affiliated group. Such return shall be filed at the time and in the office of the district director for the internal revenue district prescribed for the filing of a separate return by such common parent corporation.

(b) *Authorizations and consents.* Each subsidiary must prepare duplicate originals of Form 1122, consenting to the regulations under section 1502 and authorizing the common parent corporation to make a consolidated return on its behalf for the taxable year and authorizing the common parent (or, in the event of its failure, the Commissioner or the district director) to make a consolidated return on its behalf (as long as it remains a member of the affiliated group), for each year thereafter for which, under paragraph (a) of § 1.1502–11, the making of a consolidated return is required. One of such forms, as prepared by each subsidiary shall be attached to the consolidated return, as a part thereof; and the other shall be filed, at or before the time the consolidated return is filed, in the office of the district director for the internal revenue district prescribed for the filing of a separate return by such subsidiary. No such consent can be withdrawn or revoked at any time after the consolidated return is filed.

(c) *Affiliations schedule filed by common parent corporation.* The common parent corporation shall prepare Form 851 (Affiliations Schedule), which shall be attached to and made a part of the consolidated return.

(d) *Persons qualified to execute returns and forms.* Each return or form

required to be made or prepared by a corporation must be executed by the person authorized under section 6062 to execute returns of separate corporations. In cases where receivers or trustees in bankruptcy are operating the property or business of corporations, each return or form required to be made or prepared by such corporation must be executed by the receiver or trustee, as the case may be, pursuant to an order or instructions of the court, and be accompanied by a copy of such order or instructions.

(e) *Signatures in case subsidiary has left affiliated group.* Since Form 1122 is required even though, during the taxable year of the common parent corporation, the subsidiary (because of a dissolution or sale of stock, or otherwise) has ceased to be a member of the affiliated group, it may be advisable for the common parent to obtain the proper signatures to the form prior to the time the subsidiary ceases to be a member of the group.

§ 1.1502–13 Change in affiliated group during taxable year.[1]

(a) *General rule.* Except as hereinafter provided, a consolidated return must include the income of the common parent corporation and of each subsidiary for the entire taxable year of the affiliated group.

(b) *Formation of affiliated group after beginning of year.* If an affiliated group is formed after the beginning of the taxable year of the corporation which becomes the common parent corporation, the consolidated return must include the income of the common parent for its entire taxable year (excluding any portion of such year during which its income is included in the consolidated return of another affiliated group) and the income of each subsidiary from the time it became a member of the affiliated group.

(c) *Complete termination of affiliated group prior to close of taxable year.* If an affiliated group is terminated prior to the close of the taxable year of the group, the consolidated return must include the income of the common parent corporation for its entire taxable year (excluding any portion of such year during which its income is included in the consolidated return of another affiliated group) and of each subsidiary for the period prior to the termination. (See paragraphs (c) and (d) of § 1.1502–11 in determining whether the group has terminated.)

(d) *Addition to affiliated group of a subsidiary during year.* If a corporation becomes a member of the affiliated group during the taxable year of the group, the consolidated return must include its income from the time when it became a member of the group.

(e) *Elimination from affiliated group of a subsidiary during year.* If a subsidiary ceases to be a member of the affiliated group during the taxable year of the group, the consolidated return must include its income for the period during which it was a member of the group.

(f) *Period of 30 days or less may be disregarded.* A subsidiary may at its option be considered as having been a member of the affiliated group during the entire taxable year of the group (or during the entire period of the existence of the subsidiary, whichever is shorter) if the period during which it was not a member of such group does not exceed 30 days. If a corporation has been a member of the affiliated group for a period of less than 31 days during the taxable year of the group, it may at its option be considered as not having been a member of the group during the taxable year. An option under this paragraph must be exercised at the time the consolidated return is made.

(g) *Separate returns for periods not included in consolidated return.* If a corporation, during its taxable year (determined without regard to the affiliation), becomes a member of an affiliated group, its income for the portion of such taxable year not included in the consolidated return of such group must be included in a separate return (or, if a member of another affiliated group which makes a consolidated return for such period, then in such consolidated return). If a corporation ceases to be a member of the affiliated group during the taxable year of the group, its income for the period after the time when it ceased to be a member of the group must be included in a separate return (or, if it becomes a member of another affiliated group which makes a consolidated return for such period, then in such consolidated return).

(h) *Time for making separate returns for periods not included in consolidated return.* (1) (i) If the due date for filing a subsidiary's separate return (determined without regard to the affiliation and without regard to extensions of time) precedes the due date for filing the consolidated return of the affiliated group (determined without regard to extensions of time), then, on or before the due date of the subsidiary's separate return, it may make a separate return either for that portion of its taxable year which would not be included in the consolidated return, if such return is filed, or for its complete taxable year. However, if a separate return is filed for only a portion of its taxable year and the group does not elect to make a consolidated return, such subsidiary shall file a return for its complete taxable year not later than the due date (including extensions of time) prescribed for the filing of the consolidated return by the group. There shall be attached to the return for the complete taxable year a statement setting forth that such return is in lieu of the return previously filed. In such case the return previously filed for only a portion of its taxable year shall not be considered a return within the meaning of section 6012. On the other hand, if a return is filed for the subsidiary's complete taxable year and the group later makes a consolidated return, such subsidiary should file an amended return not later than the due date (including extensions of time) for the filing of the consolidated return of the group. Such amended return shall be for that portion of the taxable year which is not included in the consolidated return.

(ii) If the due date for filing a subsidiary's separate return (determined without regard to the affiliation and without regard to extensions of time) is later than the due date for filing the consolidated return of the affiliated group (determined without regard to extensions of time), then the separate return for that portion of the subsidiary's taxable year which is not included in the consolidated return of the group should be filed no later than the due date (including extensions of time) for the filing of the consolidated return.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation P, which reports its income on a calendar year basis, acquires all of the stock of Corporation S on January 1, 1959. Corporation S reports its income on a fiscal year ending March 31. On June 15, 1959, the due date for the filing of a separate return by Corporation S, it is anticipated that Corporation P will elect, on the due date of its return, to file a consolidated return for 1959. On June 15, Corporation S may file either a return for a short taxable year beginning April 1, 1958, and ending December 31, 1958, or it may file a return for the complete fiscal year ending March 31, 1959. If it files a return for the short taxable year and Corporation P does not elect to file a consolidated return, Corporation S must file a return for the complete fiscal year ending March 31, 1959, in lieu of the return previously filed for the short period. Interest is computed on any additional tax from June 15, 1959.

Example (2). Assume the same facts as in example (1), except that Corporation P acquires all of the stock of Corporation S on October 1, 1959, and that Corporation P elects to file a consolidated return on March 15, 1960, the due date of its return. The return of Corporation S for the short taxable year beginning April 1, 1959, and ending September 30, 1959, should be filed on March 15, 1960.

§ 1.1502–14 Accounting period of an affiliated group.

(a) The taxable year of an affiliated group which makes a consolidated return shall be the same as the taxable year of the common parent corporation; and, except as provided in paragraph (c) of this section, upon having elected to file a consolidated return, each subsidiary corporation shall, not later than the close of the first consolidated taxable year ending thereafter, adopt an annual accounting period, fiscal year or calendar year as the case may be, in conformity with that of the common parent.

(b) If a change of accounting period is necessary in order to conform the accounting periods of the common parent and of its subsidiaries, Form 1128 shall be submitted at or before the time of filing the consolidated return for the taxable year in which the subsidiary has first adopted the parent corporation's annual accounting period.

(c) If the common parent corporation of an affiliated group has a fiscal year accounting period and any member of the group is an includible insurance

[1] This section has no bearing upon the question whether a consolidated return may or must be made, but relates only to the effect of changes in the affiliated group during the taxable year.

company required by section 843 to file its return on a calendar year, the first consolidated return which includes such insurance company may be filed on the basis of the fiscal year accounting period of the common parent, provided, however, the common parent and the other includible corporations change to a calendar year basis effective immediately after the close of such fiscal year. For this purpose, Form 1128 shall be submitted at or before the time such first consolidated return is filed.

(d) With respect to computations for years involved in the change to the consolidated basis, see § 1.1502–32.

§ 1.1502–15 Liability for tax.

(a) *Several liability of members of affiliated group.* Except as provided in paragraphs (b) and (c) of this section, the common parent corporation and each subsidiary, a member of the affiliated group during any part of a consolidated return period, shall be severally liable for the tax (including any deficiency in respect thereof) computed as provided in § 1.1502–30, and for any addition to the tax computed as provided in § 1.1502–49 for underpayment of estimated tax for the consolidated return period.

(b) *Liability of a corporation in bankruptcy or receivership.* If, at the time of filing a consolidated return, one or more, but not all, of the members of the affiliated group are in bankruptcy under the laws of the United States or in receivership in any court of the United States or of any State, Territory, or the District of Columbia, then the liability under paragraph (a) of this section of each such member of the group with respect to the period covered by such return shall not exceed such portion of the consolidated tax liability for such period as the several corporations included in the consolidated return may, subject to the approval of the Commissioner, agree upon, or, in the absence of such an agreement, an amount equal to its liability for such year computed as if a separate return had been filed.

(c) *Liability of subsidiary after withdrawal.* If a subsidiary has ceased to be a member of the affiliated group, its liability under paragraph (a) of this section shall remain unchanged, except that if such cessation occurred prior to the date upon which any deficiency is assessed and resulted from a bona fide sale of stock for fair value, the Commissioner may, if he believes that the assessment or collection of the balance of the deficiency will not be jeopardized, make assessment and collection of such deficiency from such former subsidiary in an amount not exceeding the portion thereof allocable to it upon the bases of income used in the computations, respectively, of the normal tax, the surtax, and any other tax imposed by chapter 1 of the Code included in such deficiency.

(d) *Effect of intercompany agreements.* Any agreement entered into by one or more members of the affiliated group with any other members of such group or with any other person shall in no case have the effect of reducing the liability prescribed under this section.

(e) *Liability of transferee not affected.* This section shall not be considered as extinguishing or diminishing any liability, at law or in equity, of a transferee of property of a taxpayer, including any liability under any provision of law, State or Federal, relating to liabilities pursuant to corporate dissolution or transfer or distribution of assets, whether or not in connection with a merger or consolidation.

§ 1.1502–16 Common parent corporation agent for subsidiaries.

(a) *Scope of agency of common parent corporation.* Except as provided in paragraphs (b) and (c) of this section, the common parent corporation shall be for all purposes (other than the making of the subsidiary consent required by paragraph (b) of § 1.1502–12) in respect of the tax for the taxable year for which a consolidated return is made or is required, the sole agent, duly authorized to act in its own name in all matters relating to such tax, for each corporation which during any part of such year was a member of the affiliated group. The corporations, other than the common parent, shall not have authority to act for or to represent themselves in any such matter. For example, all correspondence will be carried on directly with the common parent; notices of deficiencies will be mailed only to the common parent, and the mailing to the common parent shall be considered as a mailing to each such corporation; notice and demand for payment of taxes will be given only to the common parent, and such notice and demand shall be considered as a notice and demand to each such corporation; the common parent will file petitions and conduct proceedings before the Tax Court of the United States, and any such petition shall be considered as having also been filed by each such corporation; the common parent will file claims for refund or credit; refunds will be made directly to and in the name of the common parent and will discharge any liability of the Government in respect thereof to any such corporation; and the common parent in its name will give waivers, give bonds, and execute closing agreements, offers in compromise, and all other documents, and any waiver or bond so given, or agreement, offer in compromise, or any other document so executed, shall be considered as having also been given or executed by each such corporation. Notwithstanding the provisions of this paragraph, however, any notice of deficiency, in respect of the tax for a consolidated return period, will name each corporation which was a member of the affiliated group during any part of such period, and any assessment (whether of the original tax or of a deficiency) will be made in the name of each such corporation (but a failure to include the name of any such corporation will not affect the validity of the notice of deficiency or the assessment as to the other corporations); any notice and demand for payment will name each corporation which was a member of the affiliated group during any part of such period (but a failure to include the name of any such corporation will not affect the validity of the notice and demand as to the other corporations); and any levy (or warrant or notice in respect thereof), any notice of a lien, or any other proceeding to collect the amount of any assessment, after the assessment has been made, will name the corporation from which such collection is to be made. The provisions of this paragraph shall apply whether or not a consolidated return is made for any subsequent year, and whether or not one or more subsidiaries have become or have ceased to be members of the group at any time. Notwithstanding the provisions of this paragraph, the Commissioner may, if he deems it advisable, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.

(b) *Effect of withdrawal of subsidiary.* For the purpose of the assertion, assessment, and collection of any deficiency, and of a credit or refund of any amount paid by a former subsidiary as a deficiency determined under paragraph (c) of § 1.1502–15, but for no other purpose, the agency of the common parent corporation in respect of any subsidiary which has ceased to be a member of the affiliated group shall be terminated upon the expiration of 30 days (or prior thereto if the Commissioner consents) from the date upon which such subsidiary files written notice with the Commissioner that it has ceased to be a member of the affiliated group and that it is terminating such agency. For example, if a subsidiary has ceased to be a member of the group (and if the 30-day period has expired) prior to the mailing of a notice of deficiency to the common parent, a separate notice of deficiency will be mailed in due course to the subsidiary in respect of its deficiency if it becomes necessary to enforce its liability.

(c) *Effect of dissolution of common parent corporation.* If the common parent corporation contemplates dissolution, or is about to be dissolved, or if for any other reason its existence is about to terminate, it shall forthwith notify the Commissioner of such fact and designate, subject to the approval of the Commissioner, another member of the affiliated group to act as agent in its place to the same extent and subject to the same conditions and limitations as are applicable to the common parent. If the notice thus required is not given by the common parent, the remaining members of the group may, subject to the approval of the Commissioner, designate another member of the group to act as such agent, and notice of such designation shall be given to the Commissioner. Until a notice in writing designating a new agent has been received by the Commissioner, any notice of deficiency or other communication mailed to the common parent shall be considered as having been properly mailed to the agent of the group; or, if the Commissioner has reason to believe that the existence of the common parent has terminated, he may, if he deems it advisable, deal directly

with any member of the group in respect of its liability.

§ 1.1502–17 Waivers.

(a) *Effect of waiver given by common parent corporation.* Any consent given by the common parent corporation (or by an agent in accordance with paragraph (c) of § 1.1502–16) extending the time within which an assessment may be made or levy or proceeding in court begun, in respect of the tax for a consolidated return period, shall be applicable (1) to each corporation which was a member of the affiliated group during any part of such period (whether or not any such corporation has ceased to be a member of the group), and (2) to each corporation the income of which was included in the consolidated return, or which filed Form 1122, for such period, even though it is subsequently determined that such corporation was not a member of the group.

(b) *Acceptance of waivers from common parent corporation and alleged subsidiary.* In no case will a separate waiver be accepted from a corporation the income of which was included in the consolidated return (for example, a corporation which the Commissioner determines was not a member of the affiliated group), or which filed Form 1122, unless a waiver is also obtained from the common parent, or unless the Commissioner is dealing directly with such corporation to enforce its liability.

§ 1.1502–18 Failure to comply with regulations.

(a) *Exclusion of a subsidiary from consolidated return.* If there has been a failure to include in the consolidated return the income of any subsidiary, or a failure to file any of the forms required by these regulations, notice thereof shall be given the common parent corporation by the Commissioner, and the tax liability of each member of the affiliated group shall be determined on the basis of separate returns unless such income is included or such forms are filed within the period prescribed in such notice, or any extension thereof, or unless under § 1.1502–11 a consolidated return is required for such year.

(b) *Common parent corporation incorrectly designated in consolidated return.* If a consolidated return includes a corporation as the common parent and such corporation was not (under the provisions of section 1502), the common parent, the tax liability of each corporation included in the return will be computed in the same manner as if separate returns had been made, unless, upon application, the Commissioner approves the making of a consolidated return, or unless under § 1.1502–11 a consolidated return is required for such year.

(c) *Inclusion of one or more subsidiaries not members of affiliated group.* If a consolidated return includes a corporation as a subsidiary and such corporation was not a member of the affiliated group during the consolidated return period, the tax liability of such corporation will be determined upon the basis of a separate return (but see paragraph (a) of this section), and the consolidated return shall be considered as including only the corporations which were members of the group during such period. If the consolidated return includes two or more corporations which are not members of the group but which constitute a separate affiliated group, the tax liability of the corporations constituting the separate group will be computed in the same manner as if separate returns had been made by such corporations, unless the Commissioner, upon application, approves the making of a consolidated return for the separate group, or unless under § 1.1502–11 a consolidated return is required for the separate group.

(d) *Effect of authorization and consent filed pursuant to notice.* If Form 1122 is filed by any corporation, pursuant to a notice under paragraph (a) of this section, such corporation shall be considered for all purposes as having joined in the making of the consolidated return.

(e) *Allocation of payments in the event of change by one or more corporations to separate returns.* In any case in which amounts have been assessed and paid upon the basis of a consolidated return and the tax liability of one or more of the corporations included in the consolidated return is to be computed in the same manner as if separate returns had been made, the amounts so paid shall be allocated between the affiliated group composed of the corporations properly included in the consolidated return and each of the corporations the tax liability of which is to be computed on a separate basis, in such manner as the corporations included in the consolidated return may, subject to the approval of the Commissioner, agree upon, or, in the absence of an agreement, upon the bases used in the respective computations of the normal tax, the surtax and any other tax imposed by chapter 1 of the Code, as shown upon the consolidated return.

§ 1.1502–19 Tentative carryback adjustments.

(a) *Groups with constant membership; consolidated returns only.* In the case of an affiliated group the membership of which remains unchanged and for which consolidated returns are made or are required for the taxable years involved, any statement filed under section 6164 with respect to an expected carryback and any application for a tentative carryback adjustment filed under section 6411 shall be filed by the common parent corporation and shall disclose all material facts and circumstances relating to the group as a whole. Such statement or application shall be filed on the appropriate form prescribed for such purpose, Form 1138 or Form 1139, as the case may be. Any refunds allowable under any such application will be made directly to and in the name of the common parent. The making of any such refund will discharge any liability of the Government in respect thereof to the several affiliated corporations. The common parent corporation and its several subsidiaries shall be severally liable for any amounts assessed pursuant to section 6213 (b) (2), together with any interest or penalty assessed in connection therewith.

(b) *Groups with changing membership; cases involving a separate return period.* (1) The membership of an affiliated group may change during a taxable year for which a net operating loss arises, or in the preceding taxable year affected by such net loss. Or an affiliated group making a consolidated return for the year of such net loss may have made separate returns for the preceding year; or a group making separate returns for the year of the net loss may have made a consolidated return for the preceding year. In any such case, the statement provided for in section 6164 and the application for the tentative carryback adjustment provided for in section 6411 shall be a joint statement or application concurred in and executed by each corporation which was a member of the group at any time during either of the taxable years involved in the deferment or adjustment sought. The time for the payment of taxes shall be extended under section 6164 and the adjustment provided for in section 6411 shall be made only in accordance with an agreement of the several corporations involved to be made a part of such statement or application. Any refund allowable under any such application with respect to a consolidated return period will be made directly to and in the name of the common parent corporation, and the making of any such refund will discharge any liability of the Government in respect thereof to the several affiliated corporations. The common parent corporation and its several subsidiaries shall be severally liable for any amounts assessed pursuant to section 6213 (b) (2), together with any interest or penalty assessed in connection therewith.

(2) In the absence of an agreement between the several corporations, or in the event of their failure to set forth the provisions of such an agreement as a part of their statement or application, no extension of time for the payment of any tax under the provisions of section 6164 shall be granted, and no tentative adjustment shall be made under section 6411.

(3) Notwithstanding any agreement between the several affiliated corporations, no tentative adjustment shall be made with respect to either a consolidated or a separate return period in disregard of the several liability of the several corporations with respect to any taxable year for which a consolidated return was made or was required.

§§ 1.1502–20 to 1.1502–29 [Reserved]

§ 1.1502–30 Computation of tax.

(a) *General rule.* In the case of an affiliated group which makes, or is required to make, a consolidated return for any taxable year, the tax liability of each corporation for the period during such year that it was a member of such group shall be computed, subject to the provisions of paragraph (b) of this section, upon the consolidated taxable income and the consolidated taxable income plus the aggregate of the deductions of the several affiliated corporations allowable under section 242, or, in the case of the taxes imposed by section 531, section 541

(except as provided in paragraph (b) (4) of this section), and section 802, upon the consolidated accumulated taxable income, the consolidated undistributed personal holding company income, the consolidated life insurance company taxable income, the consolidated life insurance company taxable income plus the aggregate of the deductions of the several affiliated corporations allowable under section 242, or the consolidated 1954 life insurance company taxable income, as the case may be, determined in each case in accordance with the regulations under section 1502. In the case of an affiliated group realizing long-term capital gains and computing its tax under the alternative tax provisions of section 1201, the tax shall be computed with reference to the consolidated taxable income, and the excess of the consolidated net long-term capital gain over the consolidated net short-term capital loss. The tax imposed under section 11 (c) or section 831 shall be increased for any taxable year for which an affiliated group makes or is required to make a consolidated return by 2 percent of the consolidated taxable income (computed without regard to the deduction, if any, provided in section 242 for partially tax-exempt interest).

(b) *Special rules.* The general rule prescribed in paragraph (a) of this section is subject to the following special rules:

(1) *In the case of Western Hemisphere trade corporations and regulated public utilities.* If the affiliated group filing a consolidated return includes a Western Hemisphere trade corporation, as defined in section 921, or a regulated public utility, as defined in section 1503 and paragraph (g) of § 1.1502–2, the increase of 2 percent provided in section 1503(a) in the corporation surtax rate shall be applied only on that portion of the consolidated taxable income attributable to the members of the group other than the Western Hemisphere trade corporation or the regulated public utility without any increase with respect to any partially tax-exempt interest of such Western Hemisphere trade corporation or such regulated public utility.

(2) *In case of mutual savings banks conducting life insurance business.* If the parent corporation of an affiliated group is a mutual savings bank which, if a separate return were filed, would be subject to the alternative tax of section 594 (a) (relating to a mutual savings bank conducting a life insurance business), the provisions of section 594 (a) shall apply to such group and the alternative tax of such group under section 594 (a) shall be computed with reference to the consolidated taxable income of the group attributable to such parent corporation determined without regard to any items of gross income or deductions properly allocable to the business of the life insurance department, and with reference to the income of such life insurance department determined under the provisions of section 594 (a) (2) and paragraph (b) of § 1.1502–31.

(3) *Changes in methods of accounting.* In any case in which a member of the affiliated group changes its method of accounting, if the year of the change is a year for which a consolidated return is filed (or is required to be filed), and if the requirements of section 481 (b) are met, then the tax under chapter 1 of the Code attributable to the increase in consolidated taxable income required by paragraph (c) of § 1.1502–44 shall not be greater than the tax under chapter 1 (or the corresponding provisions of prior law) which would result if the provisions of section 481(b) were applied to the corporation required to make the change in accounting method, but with the taxes for any year determined on the basis of the regulations under section 1502 (or prior consolidated returns regulations) if the income of such corporation was included in a consolidated return for such year, or on the basis of a separate return, if the income of such corporation was reported in a separate return for such year.

(4) *Personal holding companies.* In the case of an affiliated group which makes or is required to make a consolidated return for any taxable year, the tax liability of each corporation for the period during such year that it was a member of such group shall not be computed in the case of the tax imposed by section 541 upon the consolidated undistributed personal holding company income if:

(i) The affiliated group is an ineligible affiliated group as defined in section 542 (b) (2),

(ii) The affiliated group includes as a member (including the common parent corporation) an excluded corporation within the meaning of section 542 (c),

(iii) The consolidated personal holding company income is less than 80 percent of the consolidated section 542 gross income, or

(iv) At no time during the last half of the taxable year more than 50 percent in value of the outstanding stock of the parent corporation was owned directly or indirectly by or for not more than 5 individuals within the meaning of section 542 (a) (2).

If the tax liability of each corporation under section 541 is not computed upon the consolidated undistributed personal holding company income solely by reason of the application of subdivision (iii) or (iv) of this subparagraph (or both), no member of the affiliated group shall be subject to the tax under section 541 for such year or part thereof that it was a member of the affiliated group. If the tax liability of each corporation under section 541 is not computed upon the consolidated undistributed personal holding company income by reason of the application of subdivision (i) or (ii) of this subparagraph (whether or not subdivision (iii) or (iv) of this subparagraph, or both, are applicable), then such liability shall be computed by reference to the tax liability of the several members of the affiliated group which are personal holding companies within the meaning of section 542 (a) in the same manner as if such corporations had filed separate returns except that paragraph (b) (1) (i) of § 1.1502–31 shall be applicable (except with respect to dividends received from other members of the group) in the computation of gross income, personal holding company income, and undistributed personal holding company income, and section 562(d) shall be applicable in the computation of dividends paid.

§ 1.1502–31 Basis of tax computation.

In the case of an affiliated group of corporations which makes, or is required to make a consolidated return for any taxable year, and except as otherwise provided in the regulations under section 1502, the tax liability determined under § 1.1502–30 shall be determined subject to the definitions and rules of computation set forth in paragraphs (a) and (b) of this section.

(a) *Definitions* — (1) *Consolidated taxable income.* The consolidated taxable income shall be the combined taxable income of the several affiliated corporations:

(i) Minus the sum of:

(*a*) Any consolidated net operating loss deduction,

(*b*) Any consolidated section 1231 net loss, relating to net losses from involuntary conversions subject to section 1231, and from sales or exchanges of property subject to section 1231.

(*c*) Any consolidated charitable contribution deduction, but not in excess of 5 percent of the consolidated taxable income computed without regard to such consolidated charitable contribution deduction, any deductions under part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code, any consolidated net operating loss carrybacks, and any deduction under section 922 (special deduction for Western Hemisphere trade corporations),

(*d*) Any consolidated dividends received deduction,

(*e*) Any consolidated section 922 deduction,

(*f*) Any consolidated section 175 deduction, but not in excess of 25 percent of the consolidated section 175 gross income,

(*g*) Any consolidated section 247 deduction, and

(*h*) Any consolidated section 582(c) net loss,

(ii) Plus any consolidated net capital gain, or

(iii) Minus, in the case of an affiliated group including as members one or more corporations subject to the tax imposed by section 831, the combined additional capital loss deductions of such corporations authorized by section 832 (c) (5) (but in an amount not in excess of the consolidated net capital loss).

(2) *Consolidated net operating loss deduction.* The consolidated net operating loss deduction shall be an amount equal to the aggregate of the consolidated net operating loss carryovers and of the consolidated net operating loss carrybacks to the taxable year.

(3) *Consolidated net operating loss carryovers.* The consolidated net operating loss carryovers to the taxable year shall consist of:

(i) The consolidated net operating losses, if any, for the five preceding taxable years (not including as a fifth preceding taxable year any taxable year beginning prior to 1950, unless such

preceding taxable year began in 1949 and ended in 1950, and unless all members of the group for such preceding taxable year commenced business in 1949; and in such case the amount of the consolidated net operating loss for such fifth year shall not be treated as a carryover except to the extent that such consolidated net operating loss is allocable to 1950) to the extent that the consolidated net operating loss for any such preceding taxable year was not attributable to a corporation making a separate return or joining in a consolidated return filed by another affiliated group for the taxable year and was not absorbed as a carryover or carryback for preceding or intervening taxable years;

and, with respect to a net operating loss sustained by a corporation in a taxable year for which a separate return was filed, or for which such corporation joined in a consolidated return filed by another affiliated group, but subject to the limitations prescribed in paragraph (b) (3) of this section:

(ii) The amount of the net operating losses, if any, of such corporation for the five preceding taxable years (not including as a fifth preceding taxable year any taxable year beginning prior to 1950 unless such preceding taxable year began in 1949 and ended in 1950, and unless such corporation commenced business in 1949) to the extent that the net operating loss for any such preceding taxable year was not absorbed as a carryover or carryback for preceding or intervening taxable years.

See, however, paragraph (b) (21) of this section in any case in which a member of the group is an acquiring corporation in a transaction described in section 381 (a) or any member of the group is subject to the limitations provided in section 382.

(4) *Consolidated net operating loss carrybacks.* (i) The consolidated net operating loss carrybacks to the taxable year with respect to net operating losses sustained in taxable years ending after December 31, 1957, shall consist of—

(*a*) The amount of the consolidated net operating loss, if any, for the first succeeding taxable year (to the extent not attributable to a corporation making a separate return or joining in a consolidated return filed by another affiliated group for the taxable year) reduced to the extent absorbed as a carryback, consolidated or separate, as the case may be, for the first two preceding taxable years;

(*b*) The amount of the consolidated net operating loss, if any, for the second succeeding taxable year (to the extent not attributable to a corporation making a separate return or joining in a consolidated return filed by another affiliated group for the taxable year) reduced to the extent absorbed as a carryback, consolidated or separate, as the case may be, for the first preceding taxable year;

(*c*) The amount of the consolidated net operating loss, if any, for the third succeeding taxable year (to the extent not attributable to a corporation making a separate return or joining in a consolidated return filed by another affiliated group),

and, with respect to a net operating loss sustained by a corporation which, for any of the three succeeding taxable years, files a separate return or joins in a consolidated return filed by another affiliated group, but subject to the limitations prescribed in paragraph (b) (3) of this section,

(*d*) The amount of the net operating loss, if any, sustained by such corporation, for the first succeeding taxable year, reduced to the extent absorbed by such corporation for either or both of the first two preceding taxable years, or, if the income of such corporation is included in the consolidated return for either or both of the first two preceding taxable years, reduced to the extent absorbed by such consolidated return or returns;

(*e*) The amount of the net operating loss, if any, sustained by such corporation for the second succeeding taxable year, reduced to the extent absorbed by such corporation for the first preceding taxable year, or, if the income of such corporation is included in the consolidated return for the first preceding taxable year, reduced to the extent absorbed by such consolidated return; and

(*f*) The amount of the net operating loss, if any, sustained by such corporation for the third succeeding taxable year.

If the taxable year in which the net operating loss or consolidated net operating loss was sustained is a year beginning in 1957 and ending in 1958, the carryback is subject to section 172(i) or paragraph (b) (4) (v) of this section, respectively. See also paragraph (b) (21) of this section in any case in which a member of the group is an acquiring corporation in a transaction described in section 381 (a), or any member of the group is subject to the limitations provided under section 382.

(ii) The consolidated net operating loss carrybacks to the taxable year with respect to net operating losses sustained in taxable years ending before January 1, 1958, shall consist of—

(*a*) The amount of the consolidated net operating loss, if any, for the first succeeding taxable year (to the extent not attributable to a corporation making a separate return or joining in a consolidated return filed by another affiliated group for the taxable year) reduced to the extent absorbed as a carryback, consolidated or separate, as the case may be, for the first preceding taxable year;

(*b*) The amount of the consolidated net operating loss, if any, for the second succeeding taxable year to the extent not attributable to those corporations making separate returns in the taxable year;

and, with respect to a net operating loss sustained by a corporation which, for either of the two succeeding taxable years, files a separate return or joins in a consolidated return filed by another affiliated group, but subject to the limitations prescribed in paragraph (b) (3) of this section,

(*c*) The amount of the net operating loss, if any, sustained by such corporation for the first succeeding taxable year reduced to the extent absorbed by such corporation for the first preceding taxable year or, if the income of such corporation is included in the consolidated return for the first preceding taxable year, reduced to the extent absorbed by such consolidated return; and

(*d*) The amount of the net operating loss, if any, sustained by such corporation for the second succeeding taxable year.

See, however, paragraph (b) (21) of this section in any case in which a member of the group is an acquiring corporation in a transaction described in section 381 (a) or any member of the group is subject to the limitations provided in section 382.

(5) *Consolidated net operating loss.* The consolidated net operating loss shall be an amount equal to the excess of the sum of:

(i) The combined net operating losses of the several affiliated corporations having net operating losses,

(ii) The consolidated section 175 deduction, but not in excess of 25 percent of the consolidated section 175 gross income,

(iii) The consolidated section 1231 net loss,

(iv) The aggregate of the deductions of the several affiliated corporations under sections 243, 244, and 245 (computed without regard to the limitation contained in section 246(b)) and under section 247 (computed without regard to the limitation of subsection (a) (1) (B) of such section), and

(v) The consolidated section 582(c) net loss,

over the sum of—

(vi) The combined taxable income of the several affiliated corporations having taxable income, computed without regard to any deductions under section 242 (relating to partially tax-exempt interest), and

(vii) The consolidated net capital gain.

(6) *Consolidated section 1231 net loss.* The consolidated section 1231 net loss shall be the excess of the aggregate of the recognized losses of the character described in section 1231 sustained by the several affiliated corporations over the aggregate of the recognized gains of the character described in section 1231 realized by the several affiliated corporations.

(7) *Consolidated charitable contribution deduction.* The consolidated charitable contribution deduction shall be the aggregate of the amount of the deductions of the several affiliated corporations allowable under section 170 for the taxable year (determined without regard to the 5-percent limitation of section 170 (b) (2)) and an amount equal to the aggregate of the consolidated charitable contribution carryovers to the taxable year.

(8) *Consolidated charitable contribution carryovers.* The consolidated charitable contribution carryovers to the taxable year shall consist of—

(i) The excess, if any, of the amount of the consolidated charitable contribution deduction (computed without re-

gard to any charitable contribution carryovers) for the two preceding taxable years over the limitation of subparagraph (1)(i)(c) of this paragraph for such years to the extent that the consolidated charitable contribution deduction for any such preceding year was not attributable to a corporation making a separate return, or joining in a consolidated return filed by another affiliated group, for the taxable year reduced by—

(*a*) The amount absorbed as a carryover by the consolidated or separate taxable income for the intervening taxable year, and

(*b*) The increase in a consolidated or separate net operating loss carryover resulting from such excess,

and, with respect to any excess of charitable contributions over the applicable 5-percent limitation of a corporation in a taxable year for which a separate return was filed, or for which such corporation joined in a consolidated return filed by another affiliated group—

(ii) The amount of such excesses of such corporation for the two preceding taxable years reduced by:

(*a*) The amount absorbed as a carryover by the consolidated or separate taxable income for the intervening taxable year, and

(*b*) The increase in a consolidated or separate net operating loss carryover resulting from such excess.

(9) *Consolidated net capital gain.* The consolidated net capital gain shall be the excess of the sum of—

(i) The aggregate of the capital gains of the several affiliated corporations,

(ii) The consolidated section 1231 net gain, and

(iii) The consolidated section 582(c) net gain,

over the sum of—

(iv) The aggregate of the capital losses of such corporations, and

(v) The aggregate of the consolidated net capital loss carryovers to the taxable year.

(10) *Consolidated section 1231 net gain.* The consolidated section 1231 net gain shall be the excess of the aggregate of the recognized gains of the character described in section 1231 realized by the several affiliated corporations over the aggregate of the recognized losses of the character described in section 1231 sustained by the several affiliated corporations.

(11) *Consolidated net capital loss carryover.* The consolidated net capital loss carryovers to the taxable year shall consist of:

(i) The consolidated net capital losses, if any, for the 5 preceding taxable years to the extent that such losses were not attributable to a corporation making a separate return, or joining in a consolidated return filed by another affiliated group, for the taxable year, and were not absorbed by net capital gains for intervening taxable years pursuant to the provisions of section 1212 or corresponding provisions of prior law, consolidated or separate, as the case may be,

and, with respect to net capital losses sustained by a corporation for taxable years for which separate returns were filed, or for which such corporation joined in a consolidated return filed by another affiliated group,

(ii) The net capital losses, if any, sustained by such corporation for its 5 preceding taxable years to the extent that such losses were not absorbed by the net capital gains of such corporation (or, if the income of such corporation was included in a consolidated return, by the consolidated net capital gain) for intervening taxable years pursuant to the provisions of section 1212 or corresponding provisions of prior law.

(12) *Consolidated net capital loss.* The consolidated net capital loss shall be the excess of the aggregate of the capital losses of the several affiliated corporations over the sum of:

(i) The aggregate of the capital gains of such corporations,

(ii) The consolidated section 1231 net gain, and

(iii) The consolidated section 582(c) net gain,

reduced in the case of an affiliated group including as members one or more corporations subject to the tax imposed by section 831, but only for the purpose of net capital loss carryover computations, by whichever of the following amounts is the lesser—

(iv) The combined additional capital loss deductions of such corporations authorized by section 832(c)(5), or

(v) The consolidated taxable income computed without regard to capital gains and losses and without regard to any deduction for partially tax-exempt interest provided by section 242.

(13) *Consolidated dividends received deduction.* The consolidated dividends received deduction shall be the aggregate of the deductions of the several affiliated corporations allowable under sections 243, 244, and 245 (computed without regard to the limitation of section 246 (b)), but in an amount not greater than 85 percent of the consolidated taxable income computed without regard to the consolidated net operating loss deduction, the consolidated section 247 deduction, and without regard to any consolidated dividends received deduction. The limitation of the previous sentence shall not apply for any taxable year for which there is a consolidated net operating loss.

(14) *Consolidated section 247 deduction.* The consolidated section 247 deduction, relating to dividends paid by public utilities on preferred stock, shall be an amount computed as follows:

(i) First, determine the amount which is the lesser of,

(*a*) The aggregate of the dividends paid by members of the affiliated group which are public utilities within the meaning of section 247 (b) (1) on preferred stock within the meaning of section 247 (b) (2), or

(*b*) The portion of the consolidated taxable income for the taxable year attributable to such members computed without regard to the consolidated section 247 deduction.

(ii) Then multiply the amount determined under subdivision (i) of this subparagraph by the fraction specified in section 247 (a) (2).

(15) *Consolidated section 922 deduction.* The consolidated section 922 deduction, relating to Western Hemisphere trade corporations, shall be that portion of the consolidated taxable income attributable to those members of the affiliated group which are Western Hemisphere trade corporations (computed without regard to the consolidated section 922 deduction) multiplied by the fraction specified in section 922 (2).

(16) *Consolidated net long-term capital gain.* The consolidated net long-term capital gain shall be the excess of the sum of:

(i) The aggregate of the long-term capital gains of the several affiliated corporations, and

(ii) The consolidated section 1231 net gain,

over

(iii) The aggregate of the long-term capital losses of such corporations.

(17) *Consolidated net short-term capital loss.* The consolidated net short-term capital loss shall be the sum of—

(i) The aggregate of the short-term capital losses of the several affiliated corporations, and

(ii) The consolidated net capital loss carryovers,

minus

(iii) The aggregate of the short-term capital gains of such corporations.

(18) *Consolidated accumulated taxable income.* The consolidated accumulated taxable income shall be the consolidated taxable income computed without regard to any capital loss carryover, without regard to any charitable contribution deduction under section 170, without regard to any net operating loss deduction, and without regard to any deduction under part VIII (section 241 and following, except section 248) subchapter B of chapter 1 of the Code, minus the sum of:

(i) The combined Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940) and income, war profits and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164 (b) (6)), accrued during the taxable year by the several affiliated corporations, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law,

(ii) The consolidated charitable contribution deduction computed without regard to section 170(b)(2).

(iii) The excess of the sum of the capital losses of the several affiliated corporations (computed without regard to any capital loss carryover) over the sum of the capital gains of such corporations,

(iv) The excess of the consolidated net long-term capital gain over the consolidated net short-term capital loss (computed without regard to any capital loss carryover) minus the taxes imposed

by subtitle A attributable to such excess,

(v) In the case of an affiliated group including one or more holding company affiliates of a bank, as defined in section 2 of the Banking Act of 1933 (12 U.S.C. 221a), the consolidated section 601 deduction, relating to earnings or profits devoted to the acquisition of readily marketable assets, other than bank stock,

(vi) The consolidated accumulated earnings credit, and

(vii) The consolidated section 561 dividends paid deduction.

(19) *Consolidated accumulated earnings credit.* The consolidated accumulated earnings credit shall be:

(i) In the case of an affiliated group which is not a mere holding or investment group, an amount equal to such part of the aggregate of the earnings and profits for the taxable year of the several members of the group as are retained for the reasonable needs of the business of the group, minus the deduction allowed by subparagraph (18)(iv) of this paragraph, but not less than the amount (if any) by which $100,000 ($60,000 if the taxable year begins before January 1, 1958) exceeds the aggregate of the accumulated earnings and profits of the several members of the group at the close of the preceding taxable year, or

(ii) In the case of an affiliated group which is a mere holding or investment group, the amount (if any) by which $100,000 (or $60,000 if the taxable year begins before January 1, 1958) exceeds the aggregate of the accumulated earnings and profits of the several members of the group at the close of the preceding taxable year.

For the purpose of subdivision (i) of this subparagraph, the amount of the earnings and profits for the taxable year of the several members of the group which are retained is the amount by which the aggregate of the earnings and profits of the several members of the group for the taxable year exceed the consolidated section 561 dividends paid deduction for such year. For the purpose of the preceding sentence and subdivision (ii) of this subparagraph, the accumulated earnings and profits of the several members of the group at the close of the preceding taxable year shall be reduced by the dividends paid to other than members of the group under section 563 (a) (relating to dividends paid after the close of the taxable year) which are considered as paid during such taxable year.

(20) *Consolidated section 561 dividend paid deduction.* The consolidated section 561 dividends paid deduction shall be the sum of:

(i) The aggregate of the deductions allowable to the several members of the group with respect to dividends under section 561 (a) (1) and (2) determined without regard to any deductions attributable to payments made or considered to be made of dividends to other members of the group, and

(ii) In case the affiliated group is subject to tax on its consolidated undistributed personal holding company income, the consolidated dividend carryover.

(21) *Consolidated section 542 gross income.* The consolidated section 542 gross income shall be the combined gross income of the several members of the affiliated group computed without regard to any gross income from other members of the group and by including only the excess of the gains of the several members of the group over the losses of the several members of the group from transactions in stocks or securities as described in section 543 (a) (2) and by including only the excess of the gains of the several members of the group over the losses of the several members of the group with respect to commodity transactions as described in section 543 (a) (3).

(22) *Consolidated personal holding company income.* The consolidated personal holding company income shall be that part of the consolidated section 542 gross income from the sources described in section 543.

(23) *Consolidated undistributed personal holding company income.* The consolidated undistributed personal holding company income shall be the consolidated taxable income computed without regard to any deductions under part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code, without regard to any charitable contribution deduction under section 170, without regard to any net operating loss deduction, and without regard to deductions disallowed by section 545 (b) (8), minus the sum of:

(i) The combined Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164 (b) (6)) accrued during the taxable year by the several affiliated corporations but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law;

(ii) In lieu of the deduction provided by subparagraph (1)(i)(*c*) of this paragraph, the consolidated charitable contribution deduction computed without the application of section 170(b)(2) but limited as provided in section 170(b)(1)(A) and (B) (except that the 10-percent and 20-percent limitations therein shall be applied with respect to the consolidated adjusted gross income);

(iii) The amount of the consolidated net operating loss for the preceding taxable year (computed without the deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, if the current taxable year begins after December 31, 1957) to the extent not attributable to a corporation making a separate return, or joining in a consolidated return filed by another affiliated group for the taxable year, and, with respect to a corporation which filed a separate return or joined in a consolidated return filed by another affiliated group for the preceding taxable year, the net operating loss of such corporation for such preceding taxable year (computed without the deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, if the current taxable year begins after December 31, 1957) but not in excess of the portion of the consolidated personal holding company income attributable to such corporation for the taxable year;

(iv) The excess of the consolidated net long-term capital gain for the taxable year over the consolidated net short-term capital loss for such year minus the taxes imposed by subtitle A of the Code attributable to such excess;

(v) The aggregate amount subject to the provisions of section 545 (b) (7) used or irrevocably set aside by the several affiliated corporations to pay or retire indebtedness incurred prior to January 1, 1934, not including such portion of any such indebtedness as was owned on January 1, 1934, or at any time thereafter, directly or indirectly, by another member of the group;

(vi) The sum of the amounts deductible by the several members of the affiliated group allowable under section 545 (b) (9), but there shall be added to the consolidated taxable income any amount required to be included in taxable income under such section;

(vii) The consolidated section 561 dividends paid deduction; and

(viii) In the case of an affiliated group including one or more holding company affiliates of a bank, as defined in section 2 of the Banking Act of 1933 (12 U.S.C. 221a), the consolidated section 601 deduction, relating to earnings or profits devoted to the acquisition of readily marketable assets, other than bank stock.

(24) *Consolidated adjusted gross income.* The consolidated adjusted gross income shall be the consolidated taxable income computed without regard to any charitable contributions deductions, any deductions under part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, any net operating loss carryback to the taxable year, any deductions under section 922, and without deduction of the amount disallowed by section 545(b)(8).

(25) *Consolidated deficiency dividends deduction.* The consolidated deficiency dividends deduction shall be the aggregate of the amounts determined as provided in section 547 with respect to dividends distributed by the several members of the affiliated group pursuant to a determination of liability for personal holding company tax described in section 547, with respect to the consolidated undistributed personal holding company income of the affiliated group for the taxable year of the group computed without regard to any dividends distributed to members of the affiliated group.

(26) *Consolidated dividend carryover.* The consolidated dividend carryover to the taxable year shall be the sum of—

(i) The excess of—

(*a*) The consolidated section 561 dividends paid deduction for the first preceding taxable year, determined without regard to any consolidated dividend carryover, over

(*b*) The consolidated undistributed personal holding company income for such year, determined without regard to any dividends paid deduction and dividend carryover,

to the extent that such deduction and such income are not attributable to a corporation making a separate return, or joining in a consolidated return filed by another affiliated group, for the taxable year.

(ii) The amount of the consolidated section 561 dividends paid deduction (determined as provided in subdivision (i) (*a*) of this subparagraph) for the second preceding taxable year reduced by the consolidated undistributed personal holding company income for such year (determined as provided in subdivision (i) (*b*) of this subparagraph) and further reduced by the amount of the consolidated undistributed personal holding company income for the first preceding taxable year determined without regard to any dividend carryover from the second preceding taxable year to the extent that any such consolidated section 561 dividends paid deduction and any such consolidated undistributed personal holding company income are not attributable to a corporation making a separate return, or joining in a consolidated return filed by another affiliated group for the taxable year,

and, with respect to taxable years for which a member of the affiliated group filed a separate return or for which such member joined in a consolidated return filed by another affiliated group—

(iii) The excess of the deduction allowable to such corporation under section 561 for dividends paid for the first preceding taxable year (determined without regard to any dividend carryover) over the taxable income of such corporation for such year computed with the adjustments provided in section 545 (or if its income was included in the consolidated return of another affiliated group, that portion of the excess of the consolidated section 561 dividends paid deductions (determined as provided in subdivision (i) (*a*) of this subparagraph) for the first preceding taxable year, over the consolidated undistributed personal holding company income (determined as provided in subdivision (i) (*b*) of this subparagraph) for such year attributable to such corporation), and

(iv) The excess of the deduction allowable to such corporation under section 561 (determined without regard to any dividend carryover) for the second preceding taxable year over the taxable income of such corporation for such year computed with the adjustments provided in section 545 (or if its income was included in the consolidated return of another affiliated group, that portion of the excess of the consolidated section 561 dividends paid deduction (determined as provided in subdivision (i) (*a*) of this subparagraph) for the second preceding taxable year, over the consolidated undistributed personal holding company income (determined as provided in subdivision (i) (*b*) of this subparagraph) for such year, attributable to such corporation) and reduced by—

(*a*) The excess of the amount of its taxable income so computed for the first preceding taxable year over its dividends paid deduction under section 561, determined without regard to any dividend carryover from the second preceding taxable year (or, if its income was included in the consolidated return of another affiliated group, that portion of the amount of such deduction absorbed in such consolidated return of another affiliated group), or

(*b*) If the income of such corporation is included in the consolidated return for the first preceding taxable year, the excess, if any, of the consolidated undistributed personal holding company income (determined without regard to any dividends paid deduction and dividend carryover) for the first preceding taxable year over the consolidated section 561 dividends paid deduction for such year, determined without regard to any dividend carryover.

(27) *Consolidated section 601 deduction.* The consolidated section 601 deduction relating to bank affiliates, shall be an amount equal to the aggregate of the earnings or profits of members of the group which are holding company affiliates of a bank as defined in section 2 of the Banking Act of 1933 (12 U.S.C. 221a) devoted to the acquisition of readily marketable assets other than bank stock (not including any asset acquired, directly or indirectly, from another member of the group), subject, in the case of each such affiliate, to the limitations imposed by section 601 determined without regard to the qualifications expressed in paragraph (b) (1) (ii) and (iii) of this section.

(28) *Consolidated life insurance company taxable income.* The consolidated life insurance company taxable income in the case of an affiliated group consisting of corporations subject to the tax imposed by section 802 shall be the consolidated taxable income minus the consolidated section 804 deduction and plus the consolidated section 806 adjustment.

(29) *Consolidated section 804 deduction.* The consolidated section 804 deduction relating to the reserve and other policy liabilities shall be the consolidated taxable income multiplied by a figure to be determined and proclaimed by the Secretary for each taxable year pursuant to section 804.

(30) *Consolidated section 806 adjustment.* The consolidated section 806 adjustment relating to certain reserves provided in section 806 shall be an amount equal to 3¼ percent of the combined unearned premiums and unpaid losses of the several affiliated corporations on contracts other than life insurance or annuity contracts computed in the case of each corporation pursuant to the provisions of section 806 but the combined unearned premiums shall not be considered to be less than 25 percent of the combined net premiums on such other contracts written during the taxable year.

(31) *Consolidated 1954 life insurance company taxable income.* The consolidated 1954 life insurance company taxable income in the case of an affiliated group consisting of corporations subject to the tax imposed by section 802 (b) for taxable years beginning in 1954 shall be the consolidated taxable income plus eight times the consolidated section 806 adjustment and minus the consolidated reserve interest credit, if any.

(32) *Consolidated reserve interest credit.* The consolidated reserve interest credit shall be the aggregate of the reserve interest credits of the several members of the affiliated group.

(33) *Consolidated section 175 deduction.* The consolidated section 175 deduction shall be the aggregate of the amount of the deductions of the several affiliated corporations allowable under section 175 for the taxable year (determined without regard to the 25 percent limitation of section 175 (b)) and an amount equal to the aggregate of the consolidated section 175 carryovers to the taxable year.

(34) *Consolidated section 175 gross income.* The consolidated section 175 gross income shall be the combined gross income derived from farming of the several affiliated corporations engaged in the business of farming and having expenditures of the type described in section 175 (a). For this purpose, there shall be eliminated profits and losses on intercompany transactions; and proper adjustment shall be made to eliminate any distortion in the amount of gross income attributable to transactions between members of the affiliated group at markedly fictitious values.

(35) *Consolidated section 175 carryovers.* The consolidated section 175 carryovers to the taxable year shall consist of—

(i) The excess, if any, of the amount of the consolidated section 175 deductions over 25 percent of the consolidated section 175 gross income of preceding taxable years to the extent that such consolidated section 175 deduction for any preceding taxable year was not attributable to a corporation making a separate return or joining in a consolidated return filed by another affiliated group for the taxable year and was not absorbed as a carryover by the consolidated section 175 gross income for preceding taxable years

and, with respect to any excess of deductions under section 175 over the 25 percent limitation of section 175 (b) of a corporation in a taxable year for which a separate return was filed or for which such corporation joined in a consolidated return filed by another affiliated group, but subject to the limitation prescribed in paragraph (b) (15) of this section.

(ii) The amount of such excesses of such corporation for preceding taxable years to the extent that such excesses were not absorbed as carryovers for preceding taxable years.

(36) *Consolidated section 582(c) net loss.* The consolidated section 582(c) net loss shall be the excess of the aggregate of the losses of the character described in section 582(c) recognized in a taxable year beginning after December 31, 1958, by the several affiliated corporations which are banks over the aggregate of gains of the character described in section 582(c) recognized in such tax-

able year by the several affiliated corporations which are banks.

(37) *Consolidated section 582(c) net gain.* The consolidated section 582(c) net gain shall be the excess of the aggregate of the gains of the character described in section 582(c) recognized in a taxable year beginning after December 31, 1958, by the several affiliated corporations which are banks over the aggregate of the losses of the character described in section 582(c) recognized in such taxable year by the several affiliated corporations which are banks.

(b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:

(1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions);

(ii) No net operating loss deduction shall be taken into account;

(iii) No capital gains or losses shall be taken into account;

(iv) There shall be disregarded all gains and losses from involuntary conversions subject to section 1231, and from sales and exchanges of property subject to section 1231;

(v) In the computation of the deduction under section 171, relating to amortizable bond premium, there shall be disregarded the bonds of one member of the group owned by another member of the group during the taxable year;

(vi) In the computation of the taxable income of a corporation for the taxable year in which it became the common parent corporation of the affiliated group filing a consolidated return, the aggregate deductions of such corporation for such year otherwise allowable in excess of the gross income of such corporation for such year shall be excluded to the extent that such excess is attributable to that portion of such year preceding the date upon which such corporation became the common parent corporation of the group. Any amount excluded under this paragraph shall, to the extent that it constitutes a net operating loss within the provisions of section 172 or a net capital loss within the provisions of section 1222, be considered as a net operating loss or a net capital loss, as the case may be, separately sustained by such corporation and subject to the provisions of paragraph (a) (3) (ii) or (11) (ii) of this section;

(vii) In the case of a corporation which became a member of the affiliated group after January 1, 1954, common parent corporation or subsidiary, as the case may be, allowable deductions shall be determined subject to the qualifications prescribed in subparagraph (9) of this paragraph;

(viii) No deduction under section 170 with respect to charitable or other contributions shall be taken into account;

(ix) In the case of the deduction provided in section 615 (relating to mine exploration expenditures), the allowable deduction shall be determined subject to the qualifications prescribed in subparagraph (12) of this paragraph;

(x) In the case of a distribution of inventory to which section 311 (b) is applicable, or in the case of a distribution of property to which section 311 (c) is applicable by one member of the group to another member of the group, the gain recognized under such sections shall be eliminated;

(xi) No deductions under section 243, 244, 245, or 247 (relating to deductions with respect to dividends received and dividends paid) or under section 922 (relating to the special deduction for Western Hemisphere trade corporations), shall be taken into account;

(xii) No deductions under section 175 (relating to soil and water conservation expenditures) shall be taken into account by a member of an affiliated group to which the consolidated section 175 deduction is applicable; and

(xiii) In the case of a bank, for taxable years beginning after December 31, 1958, there shall be disregarded all gains and losses from sales and exchanges of property described in section 582(c).

Intercompany profits and losses which have been realized by the group through final transactions with persons other than members of the group, and intercompany transactions which do not affect the consolidated taxable income shall not be eliminated. For the purpose of this subparagraph, gain includible in income pursuant to section 357 (c) with respect to transfers of assets other than the capital assets and other than assets to which section 1231 is applicable, shall not be eliminated. For the purpose of the regulations under section 1502, a transaction not involving a sale or exchange of a capital asset or of property subject to the provisions of section 1231 shall not be considered an intercompany transaction if such transaction occurs in the regular course of the trade or business of the members of the group and if such members adopt, with the consent of the Commissioner and subject to such conditions as he deems proper, a consistent accounting practice of taking into account in the computation of consolidated taxable income the gains and losses reflected in such transactions. As used in this paragraph, the term "taxable income" includes the case in which the allowable deductions of a member (not including any net operating loss deduction) exceed its gross income.

(2) *Other computations on separate basis.* The various other computations required by the regulations under section 1502 to be made by the several affiliated corporations shall be made in the case of each such corporation in the same manner and under the same conditions as if a separate return were to be filed, but with the following exceptions:

(i) *Taxable income.* The taxable income used in any such computation shall be the taxable income of the corporation determined in accordance with the provisions of this section.

(ii) *Dividends received.* In the computation of the dividends received, there shall be excluded all dividends received from other members of the affiliated group.

(iii) *Capital gains and losses.* Capital gains and losses, short-term capital gains and losses, long-term capital gains and losses, and the additional capital loss deduction authorized by section 832 (c) (5) shall be determined without regard to:

(*a*) Gains or losses arising in intercompany transactions (other than gains described in section 357 (c)) and gains recognized to the distributing corporation pursuant to section 311 (c) by reason of distributions by one member of the group to another member of the group,

(*b*) Gains or losses from involuntary conversions and from sales or exchanges of property subject to the provisions of section 1231,

(*c*) The net capital loss carryovers provided in section 1212,

(*d*) In the case of a corporation which became a member of the affiliated group subsequent to January 1, 1954, common parent corporation or subsidiary, as the case may be, capital losses to the extent disallowed pursuant to the provisions of subparagraph (9) of this paragraph, and

(*e*) In the case of a bank, for taxable years beginning after December 31, 1958, gains or losses from sales or exchanges of property described in section 582(c).

(iv) *Net operating loss.* In the computation of the net operating loss, as defined in section 172, the provisions of this section pertaining to the determination of taxable income shall apply.

(v) *Dividends paid.* In the computation of dividends paid, there shall be excluded all dividends paid by one member of the group to another, except as provided in paragraph (b)(4) of § 1.1502-30.

(vi) *Federal income tax.* In the computation of the Federal income tax, there shall be used the consolidated tax, or a proportionate part thereof, if the tax payable is properly computed on the basis of the consolidated return.

(vii) *Dividends paid by public utility.* In the computation of dividends paid on the preferred stock of a public utility, there shall be excluded all dividends paid by such public utility to another member of the group.

(viii) *Gains or losses under section 1231.* Gains and losses from involuntary conversions subject to section 1231, and from sales or exchanges of property subject to section 1231 shall be determined without regard to—

(*a*) Gains and losses from intercompany transactions (other than gains described in section 357 (c)) and gains recognized pursuant to section 311 (c) upon the distribution of property subject to the provisions of section 1231 by one member of the group to another member of the group, and

(*b*) In the case of a corporation which became a member of the affiliated group subsequent to January 1, 1954, common parent corporation or subsidiary, as the case may be, such portion of any such loss as is disallowed pursuant to the provisions of subparagraph (9) of this paragraph.

(ix) *Mutual savings banks, domestic building and loan associations, and cooperative banks.* In the case of a mutual savings bank, a domestic building and loan association, and a cooperative bank:

(*a*) In the computation of total deposits or withdrawable accounts at the close of the taxable year for the purpose of section 593 (2) (relating to the deduction for bad debts), there shall be excluded the total deposits or withdrawable accounts of other members of the group, and

(*b*) In the computation of the deduction provided in section 591 (relating to dividends paid by banking corporations), there shall be excluded amounts paid to, or credited to the accounts of, other members of the group.

(3) *Limitations on net operating loss carryovers and carrybacks from separate return years.* In no case shall there be included in the consolidated net operating loss deduction for the taxable year as consolidated net operating loss carryovers under paragraph (a) (3) (ii) of this section (relating to the net operating losses sustained by a corporation in years for which separate returns were filed, or for which such corporation joined in a consolidated return filed by another affiliated group), and as consolidated net operating loss carrybacks under paragraphs (a) (4) (i) (*d*), (*e*) and (*f*), and (a) (4) (ii) (*c*) and (*d*) of this section (relating to a net operating loss sustained by a corporation which for any of the two or three succeeding taxable years, whichever is applicable, files a separate return or joins in a consolidated return filed by another affiliated group), an amount exceeding in the aggregate the taxable income of such corporation included in the computation of the consolidated taxable income for the taxable year decreased by its deductions under sections 243, 244, 245, 247, and 922, (and in the case of a member of an affiliated group to which the consolidated section 175 deduction is applicable, the section 175 deduction) increased by its separate net capital gain, and increased or decreased, as the case may be, with respect to its separate gains or losses from involuntary conversions subject to the provisions of section 1231, and from sales or exchanges of property subject to the provisions of section 1231. This subparagraph shall not be applicable to a carryover under paragraph (a) (3) (ii) of this section of a net operating loss of a corporation attributable to a period for which it was included in a consolidated return filed by another affiliated group for a taxable year beginning prior to January 1, 1954, all of whose members are included in the consolidated return filed for the taxable year if all of the members of such other affiliated group would have been members of the affiliated group if the law applicable to the taxable year had been applicable to such prior taxable year.

(4) *Law applicable to computations of net operating loss carryovers and carrybacks.* (i) In determining the amount of any net operating loss carryback or carryover, consolidated or separate, to any taxable year, the necessary computations involving any other taxable year shall be made under the law and regulations applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years whether they begin before, on, or after January 1, 1954.

(ii) In the case of a consolidated net operating loss for a taxable year beginning in 1953 and ending in 1954, the amount of such consolidated net operating loss which shall be carried to the second preceding taxable year shall be the amount which bears the same ratio to such consolidated net operating loss as the number of days in the loss year after December 31, 1953, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the amount absorbed for the second taxable year preceding the loss year shall not exceed the portion of the consolidated net operating loss which is carried to the second preceding taxable year.

(iii) (*a*) The consolidated net operating loss deduction for a taxable year beginning in 1953 and ending in 1954, shall be the sum of—

(*1*) That portion of the consolidated net operating loss deduction for such taxable year, computed as though paragraph (a) (2) of § 1.1502–31 applied to such taxable year, which the number of days in such taxable year after December 31, 1953, bears to the total number of days in such taxable year, and

(*2*) That portion of the consolidated net operating loss deduction for such taxable year, computed in accordance with 26 CFR (1939) 24.31(a) (2) (Regulations 129), which the number of days in such taxable year before January 1, 1954, bears to the total number of days in such taxable year.

(*b*) The consolidated net income for any taxable year beginning in 1953 and ending in 1954 which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year shall be determined in accordance with the principles of section 172(f) (4).

(iv) (*a*) The consolidated net operating loss deduction for a taxable year beginning after December 31, 1953, and ending before August 17, 1954, shall be computed as if the regulations under section 1502 apply to such taxable year.

(*b*) The consolidated net income for any taxable year beginning after December 31, 1953, and ending before August 17, 1954, which is subtracted from the consolidated net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year shall be determined in accordance with section 172(g) (3).

(v) In the case of a consolidated net operating loss for a taxable year beginning in 1957 and ending in 1958, the amount of such consolidated net operating loss which shall be carried to the third preceding taxable year shall be the amount which bears the same ratio to such consolidated net operating loss as the number of days in the loss year after December 31, 1957, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the amount absorbed for the third taxable year preceding the loss year shall not exceed the portion of the consolidated net operating loss which is carried to the third preceding taxable year.

(vi) For purposes of section 141 of the Internal Revenue Code of 1939 and that part of the regulations promulgated thereunder which relate to subchapter D, chapter 1 of such Code, excess profits net income and consolidated section 433(a) excess profits net income shall be computed as if the regulations under section 1502 did not apply and as if such section and such regulations continued to apply to taxable years beginning after December 31, 1953.

(5) *Limitation on absorption of unused dividend carryovers.* If, in the computation of the consolidated dividend carryover for the second consolidated return period in respect of which the income of a corporation is included in the consolidated return of the group, there is involved a separate unused dividend carryover of such corporation for the second preceding taxable year together with a consolidated unused dividend carryover for the second preceding taxable year, or if, for the second consolidated return period in respect of which the income of two or more members of the group is included in the consolidated return of the group, there are involved the separate unused dividend carryovers of such corporations for the second preceding taxable year, no portion of the excess of the consolidated undistributed personal holding company income (determined without regard to any dividends paid deduction and dividend carryover) over the consolidated section 561 dividends paid deduction (determined without regard to any dividend carryover) for the first preceding taxable year shall be taken into account more than once in giving effect to the provisions of paragraph (a) (26) (ii) and (iv) of this section (relating to the computation of that part of the consolidated dividend carryover attributable to the unused dividend carryovers of the second preceding taxable year).

(6) *Apportionment of consolidated net operating loss.* If an affiliated group filing a consolidated return sustains a consolidated net operating loss within the provisions of section 172, relating to the net operating loss deduction, and if there are included as members of such group one or more corporations which made separate returns, or joined in a consolidated return filed by another affiliated group, either in a preceding taxable year or in a succeeding taxable year, the portion of such consolidated net operating loss attributable to such corporations severally shall be deter-

mined, such portion in the case of any such corporation being determined in an amount proportionate to the net losses (capital net losses and ordinary net losses alike) of the several affiliated corporations having net losses, to the extent that such losses were taken into account in the computation of the consolidated net operating loss.

(7) *Apportionment of consolidated net capital loss.* If an affiliated group filing a consolidated return sustains a consolidated net capital loss, and if there are included as members of such group one or more corporations which make separate returns, or join in a consolidated return filed by another affiliated group, in a succeeding taxable year, the portion of such consolidated net capital loss attributable to such corporations severally shall be determined, such portion in the case of any such corporation being an amount which bears the same ratio to the consolidated net capital loss which the net capital loss of such corporation bears to the aggregate of the net capital losses for the taxable year sustained by the several affiliated corporations having net capital losses.

(8) *Limitation on net capital loss carryover from separate return year.* In no case shall there be included in the computation of the consolidated net capital gain for the taxable year as a consolidated net capital loss carryover under paragraph (a) (11) (ii) of this section (relating to net capital losses separately sustained) an amount exceeding in the aggregate the net capital gains of such corporation (determined without regard to any net capital loss carryover) included in the computation of the consolidated net capital gain for the taxable year increased with respect to its separate net gains from involuntary conversions and from sales or exchanges of property subject to the provisions of section 1231.

(9) *Qualifications on deductions where group membership changed after January 1, 1954.* In the case of an affiliated group formed at any time after January 1, 1954, or having among its members in the taxable year one or more subsidiaries which became members of the group subsequent to January 1, 1954, the consolidated taxable income for the taxable year, and for prior and subsequent taxable years to the extent affected by carrybacks and carryovers from the taxable year, shall be determined subject to the following qualifications:

(i) There shall be excluded in the case of the common parent corporation and in the case of any subsidiaries which were members of the group on January 1, 1954, those deductions from gross income otherwise allowable with respect to—

(*a*) Sales or exchanges of capital assets,

(*b*) Involuntary conversions and sales or exchanges of property subject to the provisions of section 1231,

(*c*) Securities subject to the provisions of section 165 (g) (3), or

(*d*) Debts subject to the provisions of section 166,

to the extent that such deductions otherwise allowable exceed in the aggregate—

(*e*) In the case of capital losses, the excess of the aggregate capital gains over the aggregate capital losses of such corporations for the taxable year, or

(*f*) In the case of ordinary losses, the aggregate of the ordinary taxable income of such corporations for the taxable year, increased in an amount equal to any excess of aggregate capital gains over aggregate capital losses of such corporations,

such capital gains and losses and such ordinary taxable income being determined pursuant to the provisions of the regulations under section 1502 but without regard to the provisions of subparagraphs (1) (iv) and (2) (iii) (*b*) of this paragraph and without regard to the losses in question:

(ii) There shall be excluded in the case of a subsidiary corporation which became a member of the affiliated group subsequent to January 1, 1954, those deductions from gross income otherwise allowable with respect to—

(*a*) Sales or exchanges of capital assets.

(*b*) Involuntary conversions and sales or exchanges of property subject to the provisions of section 1231,

(*c*) Securities subject to the provisions of section 165 (g) (3), or

(*d*) Debts subject to the provisions of section 166,

to the extent that such deductions otherwise allowable are attributable to events preceding the date upon which such corporation became a member of the group, and

(*e*) Being capital losses, exceed (*1*) the capital gains reduced by all other capital losses of such corporation for the taxable year, in the case in which such corporation was not, on January 1, 1954, a member of an affiliated group within the meaning of section 1504, or (*2*) in case such corporation was a member of an affiliated group on January 1, 1954, an amount which together with like losses computed subject to the provisions of the regulations under section 1502 in the case of other members of the group during the taxable year which were affiliated with such corporation on January 1, 1954, within the meaning of section 1504 is equal to the aggregate capital gains reduced by the aggregate of all other capital losses of such corporation and of such other members of the group, or

(*f*) Being ordinary losses exceed (*1*) the ordinary taxable income of such corporation for the taxable year increased in an amount equal to any excess of capital gains over capital losses for the taxable year, in the case in which such corporation was not, on January 1, 1954, a member of an affiliated group within the meaning of section 1504, or (*2*) in case such corporation was a member of an affiliated group on January 1, 1954, an amount which, together with like losses computed subject to the provisions of the regulations under section 1502 in the case of other members of the group during the taxable year which were affiliated with such corporation on January 1, 1954, within the meaning of section 1504, is equal to the ordinary taxable income of such corporation for the taxable year increased by the aggregate of the ordinary taxable income and decreased by the aggregate of the ordinary net losses of other members of the affiliated group during the taxable year which were affiliated with such corporation on January 1, 1954, within the meaning of section 1504, and increased further in an amount equal to any excess of aggregate capital gains over aggregate capital losses of such corporations,

such capital gains and losses, and ordinary taxable income and net losses, as the case may be, being determined pursuant to the provisions of the regulations under section 1502 but without regard to the provisions of subparagraphs (1) (iv) and (2) (iii) (*b*) of this paragraph, and without regard to the losses in question.

(iii) The portion of any loss otherwise allowable as a deduction for the taxable year which is disallowed pursuant to the provisions of subdivisions (i) and (ii) of this subparagraph shall, to the extent that it constitutes a net capital loss or a net operating loss, be considered as a net capital loss or a net operating loss, as the case may be, in respect to those members of the group by reference to which the amount of the deduction disallowed under subdivisions (i) and (ii) of this subparagraph was determined, and, for the purpose of the carryback provisions, the year of the loss shall be considered as a taxable year occurring subsequent to the last taxable year in respect of which the income of such members of the group was included in a consolidated return, and, for the purpose of the carryover provisions, as a taxable year occurring prior to the first taxable year in respect of which their income was included in a consolidated return;

(iv) The provisions of subdivisions (i) and (ii) of this subparagraph shall not apply with respect to the common parent corporation of an affiliated group formed subsequent to January 1, 1954, or to the common parent corporation or subsidiaries of a group in existence on January 1, 1954, acquiring new members subsequent to January 1, 1954, or with respect to subsidiaries becoming members of the group subsequent to January 1, 1954—

(*a*) If the group consists solely of the common parent corporation and one or more subsidiaries created, directly or indirectly, by the common parent corporation or by other members of the group;

(*b*) If, immediately after the corporation involved became a member of the group, common parent corporation or subsidiary, as the case may be, stock possessing at least 80 percent of the voting power of all classes of its stock then outstanding and at least 80 percent of each class of its nonvoting stock then outstanding is owned, directly or indirectly, by substantially the same interests by which such stock was owned on January 1, 1954;

(*c*) If the affiliated group involved was formed, or the new subsidiary became a member of the group, as an incident to an involuntary conversion or

to a transfer made pursuant to an order of the Securities and Exchange Commission, the Federal Communications Commission, the Interstate Commerce Commission, or a similar regulatory body of State or Federal Government; or

(*d*) To the extent to which, upon consideration of the facts or circumstances presented by the particular case, the Commissioner determines that a consolidated taxable income computed with respect to the affiliated group, but without regard to subdivisions (i) and (ii) of this subparagraph, will not serve to distort the income tax liability of the group or of any of its members.

(10) *Loss to group of investment in an affiliate.* In the case of a loss to one or more members of an affiliated group sustained during the taxable year as the result of the worthlessness of the investment of such members in another affiliate, whether such investment was reflected in the stock, bonds, or open account advances to such other affiliate—

(i) Such losses shall be taken into account in the computation of consolidated taxable income for the year of the loss in an amount not greater in the aggregate than the excess of the consolidated taxable income for such year computed without regard to any such loss over that portion of such consolidated taxable income so computed attributable to such other affiliate; and

(ii) The portion of any such loss otherwise allowable as a deduction for the taxable year which is disallowed pursuant to the provisions of subdivision (i) of this subparagraph shall be considered as a consolidated net operating loss to be taken into account as a consolidated carryback to the two preceding taxable years or, if the loss is sustained in a taxable year ending after December 31, 1957, the three preceding taxable years and as a consolidated carryover to the five succeeding taxable years, but in an amount not greater for any taxable year than the excess of the consolidated taxable income for such year, computed without regard to such carryover or carryback, as the case may be, over that portion of such consolidated taxable income so computed for such taxable year attributable to such other affiliate.

(11) *Disposal of timber or coal—*(i) *Intercompany transactions.* Section 631 (b) or (c) (relating to the disposal of timber or coal) shall apply to an amount received by a member of the group only to the extent such amount is received by the member of the group as a party to a transaction described in section 631 (b) or (c) with persons not members of the group.

(ii) *Application of sections 531 and 541 to coal royalties.* For the purpose of determining the consolidated accumulated taxable income and the consolidated undistributed personal holding company income the provisions of 631 (c) shall not apply to any amount received by a member of the group upon the disposal of coal.

(12) *Mine exploration expenditures—*(i) *Limitation under section 615 (a).* If the aggregate of the deductions, computed without regard to this sentence, allowable under section 615 (a) to the several members of the group exceeds $100,000,

(*a*) The deduction under that section allowable to any member of the group shall be an amount which bears the same ratio to $100,000 as its deduction computed without regard to this sentence bears to the aggregate of such deductions so computed for the members of the group, except that,

(*b*) If all the members of the group consent in writing, the deduction under that section allowable to such member shall be the deduction under that section computed without regard to this sentence, or such part thereof as the common parent corporation shall determine at the time the consent is filed, provided, however, that the aggregate of the deductions so allowable for all members of the group shall not exceed $100,000.

(ii) *Limitation under 615 (c).* If the limitation provided in section 615 (c) is applicable to any member of the group, such limitation shall be deemed applicable to all members of the group.

(13) *Apportionment of unused dividend carryover and allowance of consolidated deficiency dividends deduction—*(i) *Apportionment of unused dividend carryover.* If an affiliated group filing a consolidated return has an unused consolidated dividend carryover and if there are included as members of such group one or more corporations which make separate returns, or join in a consolidated return filed by another affiliated group or if any member of the group computes its tax liability under section 541 pursuant to the last sentence of paragraph (b)(4) of § 1.1502-30, in a succeeding taxable year, the portion of such unused consolidated dividend carryover attributable to such corporations severally shall be determined for the purpose of the dividend carryover, such portion in the case of any such corporation shall be determined in an amount proportionate to the deduction for dividends paid and the taxable incomes of the several affiliated corporations (determined with the adjustments provided in section 545) to the extent that such deduction and such taxable income were taken into account in the computation of the consolidated dividend carryover and the consolidated and undistributed personal holding company income.

(ii) *Deficiency dividends deduction.* For the purpose of applying section 547, relating to deficiency dividends, in case the affiliated group is subject to tax on its consolidated undistributed personal holding company income for the taxable year to which the deficiency in personal holding company tax relates, the consolidated deficiency dividends deduction described in paragraph (a) (25) of this section shall be allowed.

(14) *Apportionment of consolidated charitable contribution deduction.* If an affiliated group filing a consolidated return has an excess of the consolidated charitable contribution deduction over the limitation of paragraph (a) (1) (i) (*c*) of this section for the taxable year, and if there are included as members of such group one or more corporations which make separate returns or join in a consolidated return filed by another affiliated group in a succeeding taxable year, the portion of such excess attributable to such corporations severally shall be determined, such portion in the case of any such corporation being determined in an amount proportionate to such excess as the contributions of each such corporation bear to the aggregate of such contributions.

(15) *Limitation on section 175 carryovers from separate return years.* In no case shall there be included in the consolidated section 175 deductions for the taxable year as consolidated section 175 carryovers under paragraph (a) (35) (ii) of this section (relating to excess section 175 deductions of a corporation for years for which separate returns were filed or for which such corporation joined in a consolidated return filed by another affiliated group), an amount exceeding in the aggregate the amount by which 25 percent of the gross income of such corporation derived from farming included in the computation of the consolidated section 175 gross income for the taxable year exceeds the amount of the expenditures of such corporation of the taxable year deductible under section 175.

(16) *Apportionment of consolidated section 175 deduction.* If an affiliated group filing a consolidated return has an excess of the consolidated section 175 deduction over the limitation of 25 percent of the consolidated section 175 gross income for the taxable year, and if there are included as members of such group one or more corporations which make separate returns, or are joined in a consolidated return filed by another affiliated group, in a succeeding taxable year, the portion of such excesses attributable to such corporations severally shall be determined; such portion in the case of any such corporation being determined in an amount proportionate to such excess as the deductions of each such corporation bears to the aggregate of such deductions.

(17) *Applicability of consolidated section 175 deduction.* An affiliated group shall not be eligible to use the consolidated section 175 deduction unless all of the members of such group which are engaged in the business of farming during the taxable year have adopted, pursuant to section 175 (d), the method described in section 175. In the case of a corporation which is a member of an affiliated group which is not eligible to use the consolidated section 175 deduction, the deduction provided by section 175 shall be used in the computation of the taxable income of such corporation in the same manner and under the same conditions as if a separate return were to be filed, except that the gross income from farming of such corporation shall be determined without regard to profits or losses on intercompany transactions; and proper adjustment shall be made to eliminate any distortion in the amount of gross income attributable to transactions between members of the group at markedly fictitious values.

(18) *Computation of consolidated accumulated taxable income.* In the computation of consolidated accumu-

lated taxable income no amount shall be taken into account with respect to any income or deductions attributable to members of the affiliated group which are subject to tax under section 541 as described in the last sentence of paragraph (b) (4) of § 1.1502–30.

(19) *Law applicable to the computation of consolidated dividends carryover.* In the computation of the consolidated section 561 dividends paid deduction, the amount of the consolidated dividends carryover from a year to which subtitle A of the Code is not applicable to a taxable year to which such subtitle applies shall be determined under 26 CFR (1939) part 24 (Regulations 129) if a consolidated return was filed for the year in which the dividends were paid or under the provisions of the Internal Revenue Code of 1939 if a separate return was filed for such year.

(20) *Law applicable to computation of deficiency dividends deduction.* If a deficiency is asserted with respect to a taxable year which began before January 1, 1954, the amount of any "deficiency dividend" shall include only amounts which would have been includible in the computation of the consolidated basic surtax credit, as defined in 26 CFR (1939) Part 24 (Regulations 129), or in the computation under the Internal Revenue Code of 1939 of the basic surtax credit for such taxable year, as the case may be.

(21) *Rules with respect to net operating losses under sections 381 and 382.* (i) If, in the computation of the consolidated net operating loss carryover, there is included an amount with respect to a net operating loss of a corporation, sustained in a taxable year for which it filed a separate return or for which such corporation joined in a consolidated return filed for another affiliated group, which is a transferor or distributor of assets to a member of the affiliated group within the meaning of section 381 (a), the amount allowable as a carryover with respect to such transferor or distributor shall not exceed the amount of the taxable income of the acquiring corporation included in the computation of the consolidated taxable income for the taxable year. The computation shall be made as described in subparagraph (3) of this paragraph as though the acquiring corporation had sustained a net operating loss in a year for which separate returns were filed or for which the acquiring corporation had joined in a consolidated return filed by another affiliated group.

(ii) If, in addition to the amount described in subdivision (i) of this subparagraph, there is included an amount with respect to a net operating loss sustained by the acquiring corporation in a year for which it filed separate returns or for which it joined in a consolidated return filed by another affiliated group, the losses sustained by both the acquiring corporation and the transferor or distributor corporation which may be taken into account as a net operating loss deduction in determining the consolidated taxable income may not exceed the taxable income of the acquiring corporation computed in a manner described in subparagraph (3) of this paragraph.

(iii) For purposes of subdivisions (i) and (ii) of this subparagraph, if the transferor or distributor corporation was a member of another affiliated group which filed a consolidated return, the amount of the consolidated net operating loss of such affiliated group, if any, attributable to such transferor or distributor, shall be treated as the net operating loss of such corporation separately sustained.

(iv) In any case in which a consolidated net operating loss was sustained by an affiliated group which includes a member whose net operating loss is subject to the limitations upon net operating losses provided by section 382, such section shall be applicable with respect to such member as if the portion of such consolidated net operating loss attributable to such corporation were a net operating loss of such corporation separately sustained.

(22) *Rules with respect to capital loss carryovers under section 381.* (i) If in the computation of the consolidated net capital loss carryovers for a taxable year there is included an amount with respect to a net capital loss of a corporation, sustained in a taxable year for which it filed a separate return or for which such corporation joined in a consolidated return filed by another affiliated group, which is a transferor or distributor of property to a member of the affiliated group within the meaning of section 381 (a), the amount allowable with respect to such transferor or distributor shall not exceed the net capital gains of the acquiring corporation (determined without regard to any net capital loss carryover) included in the computation of the consolidated net capital gain for the taxable year increased with respect to its separate gains for involuntary conversions and from sales or exchanges of property subject to the provisions of section 1231.

(ii) If there is included under paragraph (a) (11) (ii) of this section an amount with respect to net capital losses separately sustained by such acquiring corporation in years for which separate returns were filed or for which such corporation joined in a consolidated return filed by another affiliated group, the limitation described in subdivision (i) of this subparagraph shall be applicable with respect to the aggregate of such losses and the losses of its transferor or distributor corporations.

(iii) For purposes of subdivisions (i) and (ii) of this subparagraph, if the transferor or distributor corporation was a member of another affiliated group which filed a consolidated return, the amount of the consolidated net capital loss of such affiliated group, if any, attributable to such transferor or distributor, shall be treated as the net capital loss of such corporation separately sustained.

(c) *Statements and schedules for subsidiaries.* The statement of gross income and deductions and the several schedules required by the instructions on the return must be prepared and filed by the common parent corporation in columnar form so that the details of the items of gross income, deductions, and credits, for each member of the affiliated group, may be readily audited. Such statements and schedules shall include in columnar form a reconciliation of surplus for each such corporation, together with a reconciliation of the consolidated surplus. Consolidated balance sheets as of the beginning and close of the taxable year of the group, taken from the books of the members of the group, shall accompany the consolidated return prepared in a form similar to that required for reconciliation of surplus. If any member of the affiliated group computes its tax under section 541 in the manner provided in paragraph (b) (4) of § 1.1502–30, a personal holding company schedule for such corporation shall be filed with the consolidated return.

(d) *Net operating loss deduction, excess charitable contributions, excess section 175 deductions, and dividend carryover before or after consolidated return*—(1) *Net operating loss deduction.* The consolidated net operating loss of an affiliated group shall be used in computing the consolidated net operating loss deduction notwithstanding that one or more members of the group in the taxable year in which such loss originates make separate returns (or join in a consolidated return made by another affiliated group) for a subsequent taxable year (or in the case of a carryback computation for a preceding taxable year), but only to the extent that such consolidated net operating loss is not attributable to such corporations. Such portion of such consolidated net operating loss as is attributable to the several corporations making separate returns (or joining in a consolidated return made by another affiliated group) for a subsequent taxable year (or in the case of a carryback computation for a preceding taxable year) shall be used by such corporations severally as carryovers or as carrybacks in such separate returns or in such consolidated returns of the other affiliated group. Any net operating loss separately sustained by a corporation prior to a first taxable year in respect of which its income is included in the consolidated return of the group (or sustained in either of the two taxable years immediately following a consolidated return year or any of the three taxable years so following if sustained in a taxable year ending after December 31, 1957) shall be used in computing the net operating loss deduction of such corporation (or the consolidated net operating loss deduction of another affiliated group of which it becomes a member) for a subsequent taxable year for which it makes a separate return or joins in a consolidated return of another group, but only to the extent that such net operating loss was not absorbed (either as a carryover or as a carryback) in the computation of the consolidated net operating loss deduction for consolidated return periods.

(2) *Excess charitable contributions.* The excess of the consolidated charitable contributions over the 5-percent limitation of paragraph (a) (1) (i) (c) of this

section shall be used in computing the consolidated charitable contribution carryover notwithstanding that one or more members of the group in the taxable year in which such carryover originates make separate returns (or join in a consolidated return made by another affiliated group) for a subsequent taxable year, but only to the extent that such excess charitable contribution is not attributable to such corporations. Such portion of such excess charitable contributions as is attributable to the several corporations making separate returns (or joining in a consolidated return made by another affiliated group) for a subsequent taxable year shall be used by such corporations severally as carryovers in such separate returns or in such consolidated returns of the other affiliated group. Any excess of charitable contributions of a corporation for the year prior to a first taxable year in respect of which its income is included in the consolidated return of the group shall be used in computing the charitable contribution deduction of such corporation (or the consolidated charitable contribution deduction of another affiliated group of which it becomes a member) for a subsequent taxable year for which it makes a separate return or joins in a consolidated return of another group, but only to the extent that such excess charitable contribution was not absorbed as a carryover in the consolidated charitable contribution deduction for consolidated return periods. In applying this paragraph, the excess of the consolidated charitable contributions over the 5-percent limitation shall be reduced by the increase in a consolidated or separate net operating loss carryover resulting from such excess.

(3) *Excess section 175 deductions.* The excess of the deductions under section 175 over the limitation of 25 percent provided in paragraph (a) (1) (i) (*f*) of this section shall be used in computing the consolidated section 175 carryover notwithstanding that one or more members of the group in the taxable year in which such carryover originates make separate returns (or join in a consolidated return made by another affiliated group) for a subsequent taxable year, but only to the extent that such excess section 175 deduction is not attributable to such corporations. Such portion of such excess section 175 deductions as is attributable to the several corporations making separate returns (or joining in a consolidated return made by another affiliated group) for a subsequent taxable year shall be used by such corporations severally as carryovers in such separate returns or in such consolidated returns of the other affiliated group. Any excess of section 175 deductions of a corporation for a year prior to a first taxable year in respect of which its income is included in the consolidated return of the group shall be used in computing the section 175 deduction of such corporation (or the consolidated section 175 deduction of another affiliated group of which it becomes a member) for a subsequent taxable year for which it makes a separate return or joins in a consolidated return of another group, but only to the extent that such excess section 175 deduction was not absorbed as a carryover in the computation of a consolidated section 175 deduction for consolidated return periods.

(4) *Unused consolidated dividend carryover.* The unused consolidated dividend carryover shall be used in computing the consolidated dividend carryover notwithstanding that one or more members of the group in the taxable year in which such carryover originates make separate returns (or join in a consolidated return made by another affiliated group) for a subsequent taxable year, but only to the extent that such unused consolidated dividend carryover is not attributable to such corporations. Such portion of such unused consolidated dividend carryover as is attributable to the several corporations making separate returns or computing their tax liability under section 541 pursuant to the last sentence of paragraph (b) (4) of § 1.1502–30 (or joining in a consolidated return made by another affiliated group) for a subsequent taxable year shall be used by such corporations severally as carryovers in such separate returns, in such separate computations under section 541, or in such consolidated returns of the other affiliated group. Any unused dividend carryover of a corporation separately produced for a year prior to a taxable year in respect of which its tax liability under section 541 is computed upon the consolidated undistributed personal holding company income shall be used in computing the dividend carryover of such corporation (or the consolidated dividend carryover of another affiliated group of which it becomes a member) for a subsequent taxable year for which it makes a separate return or joins in a consolidated return of another group, but only to the extent that such unused dividend carryover was not absorbed in the computation of the consolidated section 561 dividends paid deduction for the intervening consolidated return period.

(e) *Taxable year of less than 12 months.* Any period of less than 12 months for which either a separate return or a consolidated return is filed under the provisions of § 1.1502–13 shall be considered as a taxable year.

§ 1.1502–32 Method of computation of income for period of less than 12 months.

If a corporation, during the taxable year of the group, becomes a member or ceases to be a member of an affiliated group which makes or is required to make a consolidated return for such year, the income of such corporation to be included in the consolidated return shall be computed on the basis of its income as shown by its books if the accounts are so kept that the income for the period during which it is a member of the group can be clearly and accurately determined. If the accounts are not so kept, the income to be included in the consolidated return shall be computed on the basis of that proportion of its income (subject to the elimination of items exempt from the taxation and the addition of items not allowable as deductions) for the full period covered by its books which the number of days for which its income is included in the consolidated return bears to the number of days in the full period covered by its books; but, in the discretion of the Commissioner, there may be eliminated before the proration is made items of income or deduction clearly and accurately determined to be attributable to particular periods, and, after the proration is made, such eliminated items will be added to (if items of income) or deducted from (if deductible items) the income determined by proration for the period to which such items are applicable.

§ 1.1502–33 Gain or loss from sale of stock, or bonds or other obligations.

Gain or loss from the sale or other disposition (whether or not during a consolidated return period), by a corporation which during any period of time has been a member of an affiliated group which makes or is required to make a consolidated return, of any share of stock or any bond or other obligation issued or incurred by another corporation which during any part of such period was a member of the same group, shall be determined, and the extent to which such gain or loss shall be recognized and shall be taken into account shall also be determined, in the same manner, to the same extent, and upon the same conditions as though such corporations had never been affiliated except—

(a) In the case of a disposition (by sale, or in complete or partial liquidation not involving cash in an amount in excess of the adjusted basis of both the stock and the bonds and other indebtedness liquidated, or otherwise) during a consolidated return period to another member of the group (§§ 1.1502–31 and 1.1502–37);

(b) That the basis for determining the gain or loss, in the case of shares of stock, or in the case of bonds or other obligations, held during any part of a consolidated return period, shall be determined in accordance with §§ 1.1502–34 and 1.1502–35; and

(c) As provided in § 1.1502–36 (imposing certain limitations upon losses otherwise allowable upon sales of stock, or bonds or other obligations).

§ 1.1502–34 Sale of stock; basis for determining gain or loss.

(a) *Scope of section.* This section prescribes the basis for determining the gain or loss upon any sale or other disposition (hereinafter referred to as "sale") by a corporation which is (or has been) a member of an affiliated group which makes (or has made) a consolidated return for any taxable year, of any share of stock issued by another member of such group (whether issued before or during the period that it was a member of the group and whether issued before, during, or after the taxable year 1929), and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations under section 1502.

For the basis in the case of a sale of bonds, see § 1.1502–35.

(b) *Sales made while selling corporation is member of affiliated group.* If the sale is made within a period during which the selling corporation is a member of the affiliated group, whether or not during a consolidated return period, and whether or not, as a result of such sale, the issuing corporation ceases to be a member of the group, the basis shall be determined as follows:

(1) The aggregate bases of all shares of stock of the issuing corporation held by each member of the affiliated group (exclusive of the issuing corporation) immediately prior to the sale, shall be determined separately for each member of the group, and adjusted in accordance with the other provisions of subtitle A of the Code, but without regard to any adjustment under the last sentence of section 1051 relating to losses of the issuing corporation sustained by such corporation after it became a member of the group.

(2) From the combined aggregate bases as determined in subparagraph (1) of this paragraph, there shall be deducted the sum of—

(i) All losses of such issuing corporation sustained during taxable years for which consolidated income tax returns were made or were required (whether the taxable year 1929 or any prior or subsequent taxable year) after such corporation became a member of the affiliated group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as net loss or net operating loss in computing its net income or taxable income, as the case may be, for such taxable years if it had made a separate return for each of such years,

(ii) With respect to each of such taxable years for which consolidated returns were made or were required both for income and for excess profits tax purposes, the excess, if any, of all losses of such issuing corporation for such year, properly adjusted in the computation of consolidated excess profits net income over the amount of such losses for such year computed under subdivision (i) of this subparagraph to the extent that such excess could not have been availed of by such corporation as a net operating loss in computing its excess profits net income for such taxable years if it had made a separate return for each of such years, and

(iii) With respect to each of such taxable years for which consolidated returns were made or were required for excess profits tax purposes only, all losses of such issuing corporation for such year, properly adjusted in the computation of consolidated excess profits net income, to the extent that such losses could not have been availed of by such corporation as a net operating loss in computing its excess profits net income for such taxable years if it had made a separate excess profits tax return for each of such years,

reduced by any losses of the issuing corporation apportioned under this section to its stock sold or otherwise disposed of in a prior transaction, disregarding any transaction between members of the affiliated group during a consolidated income or excess profits tax return period which did not constitute a partial liquidation of the issuing corporation. For any taxable year in which the group sustained a consolidated loss not availed of in prior or subsequent years as a deduction under net loss or net operating loss provisions, the amount deducted under this subparagraph shall be further reduced by an amount equal to that proportion of such consolidated loss which the loss of the issuing corporation for the year in which such loss was sustained bears to the aggregate losses of the members of the group for such year.

(3) The sum of the aggregate bases of all shares of stock, after making the deduction under subparagraph (2) of this paragraph, shall then be apportioned among the members of the affiliated group which hold stock of the issuing corporation, by allocating to each such member that proportion of the sum of the aggregate bases so reduced which the aggregate basis of the stock in the issuing corporation held by such member bears to the sum of the aggregate bases.

(4) The aggregate basis as determined under subparagraph (3) of this paragraph for each member of the affiliated group shall then be equitably apportioned among the several classes of stock of the issuing corporation held by such member according to the circumstances of the case—ordinarily by allocating to each class of such stock that proportion of the aggregate basis which the basis of each class of such stock held by it at the time of the sale is to the sum of the bases of the several classes of such stock held by it.

(5) The basis of each share of stock of each class held by a member of the affiliated group shall then be determined by dividing the basis apportioned to such class under subparagraph (4) of this paragraph by the total number of shares of such class held by it.

(c) *Sales after selling corporation has ceased to be member of affiliated group.* If the sale is made after the selling corporation has ceased to be a member of the affiliated group, such basis shall be determined in accordance with paragraph (b) of this section, except that—

(1) The aggregate basis (under paragraph (b) (1) of this section) shall be determined for all shares of the issuing corporation held by each member of the group immediately prior to the time the selling corporation ceased to be a member of the group (rather than immediately prior to the sale);

(2) The reduction (under paragraph (b) (2) of this section) with respect to losses apportioned to stock sold or otherwise disposed of in prior transactions shall be determined without regard to the transaction which terminated the affiliation and all subsequent transactions;

(3) The allocation (under paragraph (b) (3) of this section) shall be made to each member of the group which held stock of the issuing corporation immediately prior to the time the selling corporation ceased to be a member of the group (rather than to the members holding such stock at the time of the sale); and

(4) The basis of each share of stock held by the selling corporation (determined, as above, as of the time the selling corporation ceased to be a member of the group) shall then be adjusted in accordance with the other provisions of subtitle A of the Code in order to determine the basis at the time of the sale.

(d) *Definition of "loss", "consolidated loss", "net loss", or "net operating loss", and "consolidated excess profits net income".* As used in this section the term "loss" means either the excess over the gross income of the issuing corporation of the sum of its allowable deductions (not including any net loss or net operating loss deduction) allowable in computing consolidated taxable income or the excess over the gross income of the issuing corporation of the sum of its allowable deductions (not including any net loss or net operating loss deduction), plus the proportionate part properly attributable to such corporation of the credits relating to interest on certain Government obligations and dividends received allowable in computing consolidated normal tax net income, the consolidated special class net income or consolidated net income subject to tax determined in accordance with the Internal Revenue Code of 1939 and provisions of consolidated returns regulations applicable to the period. The term "consolidated loss" means the excess of the sum of the losses, separately computed, over the sum of the normal tax net income, the special class net income, the net income subject to tax or the taxable income determined in accordance with the provisions of subtitle A of the Internal Revenue Code of 1954, or the Internal Revenue Code of 1939, or the Revenue Act, and pursuant to the provisions of consolidated returns regulations applicable to the period; the term "net loss" or "net operating loss" means the net loss or net operating loss, as the case may be, determined in accordance with the provisions of subtitle A of the Internal Revenue Code of 1954, or the Internal Revenue Code of 1939, or the Revenue Act, and pursuant to the provisions of consolidated returns regulations applicable to the period; and the term "consolidated excess profits net income" means the consolidated excess profits net income or consolidated section 433 (a) excess profits net income determined in accordance with the provisions of the Internal Revenue Code of 1939 or the Revenue Act and pursuant to the provisions of consolidated returns regulations applicable to the period.

§ 1.1502–35 Sale of bonds or other obligations; basis for determining gain or loss.

In the case of a sale or other disposition by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated income tax or excess profits tax return for any taxable year, of bonds or other obligations issued or incurred by another member of such group (whether or not issued or incurred while it was a member of the group and whether issued or incurred before, dur-

ing, or after the taxable year 1929) and held by the selling corporation during any part of a period for which a consolidated return is made or required under the regulations under section 1502, the basis of each bond or obligation, for determining the gain or loss upon such sale or other disposition, determined in accordance with the other provisions of subtitle A of the Code, but without regard to any adjustment under the last sentence of section 1051, shall be decreased (except as otherwise provided in this section) by the excess, if any, of the aggregate of the deductions computed under paragraph (b)(2) or (c) of § 1.1502–34 over the sum of the aggregate bases of the stock of the debtor corporation as computed under paragraph (b)(1) or (c) of § 1.1502–34 as the case may be, held by the members of the group. The adjustment with respect to so much of such deductions as is based upon losses sustained during the taxable year 1929 and subsequent taxable years for which the last day prescribed by law for the filing of the return fell on or before March 1, 1945 (the date on which Treasury Decision 5441 was filed with the Division of the Federal Register), and availed of on consolidated returns filed for such years shall be made only in those cases in which the sales or other disposition of such bonds or other obligations resulted in a loss. See also § 1.1502–40 relating to disallowance of loss upon intercompany bad debts.

§ 1.1502–36 Limitation on allowable losses on sale of stock, or bonds, or other obligations.

(a) *General rule.* No loss shall be allowed under §§ 1.1502–33, 1.1502–34, or 1.1502–35 upon the sale or other disposition of stock or bonds or obligations to the extent that such loss is attributable to—

(1) Transfers of assets within the affiliated group (by sale, gift, or otherwise) without consideration or at markedly fictitious values, during the period in which the corporations were affiliated (whether or not a consolidated return was made), or

(2) A distribution during a period in which the corporations were affiliated of earnings or profits accumulated prior to the date upon which the distributing corporation became a member of the group.

(b) *Qualification of general rule.* Paragraph (a) of this section shall not be considered as in any way limiting the operation of the provisions of subtitle A of the Code relating to the basis for determining gain or loss upon the sale or other disposition of property, but as being in amplification of and not in substitution for such provisions; subject, however, to this qualification: that to the extent that the transfers of assets referred to in paragraph (a) of this section are taken into account under the terms of subtitle A in making adjustments in the basis, such transfers will not be taken into account, in denying losses under paragraph (a) of this section.

§ 1.1502–37 Liquidations; recognition of gain or loss.

(a) *During consolidated return period.* (1) Gain or loss shall not be recognized upon a distribution during a consolidated return period, by a member of an affiliated group to another member of such group, in cancellation or redemption of all or any portion of its stock, except—

(i) Where such distribution is in complete liquidation and redemption of all of its stock (whether in one distribution or a series) and of its bonds and other indebtedness, if any, and falls without the provisions of section 332, and is the result of a bona fide termination of the business and operations of such member of the group, in which case the adjustments specified in §§ 1.1502–34 and 1.1502–35 shall be made, and § 1.1502–36 shall be applicable; or

(ii) Where such a distribution without the provisions of section 332 is one made in cash in an amount in excess of the adjusted basis of the stock, and bonds and other indebtedness, in which case gain shall be recognized to the extent of such excess.

(2) When the business and operations of the liquidated member of the affiliated group are continued by another member of the group, it shall not be considered a bona fide termination of the business and operations of the liquidated member. With respect to the acquisition of its bonds by the issuing company, see paragraph (b) of § 1.1502–41.

(3) For the purpose of determining whether an affiliated corporation receiving property in a liquidating distribution qualifies under the provisions of section 332 (b) (1), the aggregate amount of the stock of the liquidated corporation owned by the several members of the affiliated group on the date of the adoption of the plan of liquidation and at all times, subsequent thereto and prior to the receipt of the property in liquidation shall be considered as owned by the distributee.

(b) *After consolidated return period.* In case any such distribution is made after a consolidated return period, whether in complete or partial liquidation, except a complete liquidation within the provisions of section 332 (b), with respect to stock and with respect to bonds, debentures, notes, certificates, and other indebtedness of the liquidated corporation acquired prior to or during any taxable year subsequent to 1928 for which a consolidated income or excess profits tax return was filed, the adjustments specified in §§ 1.1502–34 and 1.1502–35 shall be made, and § 1.1502-36 will be applicable.

§ 1.1502–38 Basis of property.

(a) *General rule.* Subject to the provisions of paragraphs (b) and (c) of this section and except as otherwise provided in §§ 1.1502–34, 1.1502–35, and 1.1502–39, the basis during a consolidated return period for determining the gain or loss from the sale or other disposition of property, or upon which exhaustion, wear and tear, obsolescence, amortization, and depletion are to be allowed, shall be determined and adjusted in the same manner as if the corporations were not affiliated, whether such property was acquired before or during a consolidated return period. Except as otherwise provided in § 1.1502–39, such basis immediately after a consolidated return period (whether the affiliation has been broken or whether the privilege of making a consolidated return is not exercised) shall be the same as immediately prior to the close of such period.

(b) *Intercompany transactions.* The basis prescribed in paragraph (a) of this section shall not be affected by reason of a transfer during a consolidated return period, other than upon liquidation as provided in paragraph (c) of this section (whether by sale, gift, dividend, or otherwise) from a member of the affiliated group to another member of such group.

(c) *Basis after liquidation.* (1) Where property is acquired upon a distribution described in paragraph (a) of § 1.1502–37 in which gain or loss is recognized to the distributee, the basis of such property shall be its fair market value at date of acquisition.

(2) Where property is acquired upon a liquidation to which section 332 is applicable and if the first distribution in pursuance of the plan of liquidation occurs on or after June 22, 1954—

(i) Unless subdivision (ii) of this subparagraph is applicable, the basis of such property shall be the same as it would be in the hands of the transferor;

(ii) If the basis of such property is determined under 334 (b) (2), such section shall be applicable in determining the basis of property received on the liquidation (except property received by the liquidating corporation from other members of the affiliated group during a consolidated return period) and to any property transferred by the liquidating corporation to other members of the group during a consolidated return period as if such property had not been transferred and was received in such liquidation. In addition, proper adjustment shall be made with respect to the effect of any other transactions between members of the group during a consolidated return period which creates a distortion of income or a substantial variation in basis of property from the basis such property would have had if there had been no such transactions.

(3) Where property is acquired upon a distribution (not a complete liquidation within the provisions of section 332 (b)) in which gain or loss to the distributee is not recognized as provided in paragraph (a) of § 1.1502–37 the basis of such property shall be the same as the basis of the stock and the bonds and other obligations exchanged therefor, adjusted for—

(i) The transfer of assets within the affiliated group by the distributing corporation (by sale, gift, or otherwise) without consideration or at markedly fictitious values, during the period for which the corporations were affiliated (whether or not a consolidated return was made);

(ii) Distributions during a period in which the corporations were affiliated of earnings or profits accumulated prior to the date upon which the distributing corporation became a member of the group; and

(iii) Cash received in the distribution.

(4) Where property was acquired upon a distribution in which gain or loss to the distributee was recognized pursuant to the provisions of section 333 (a) or the corresponding provisions of the Internal Revenue Code of 1939 or the Revenue Act of 1938, the basis of such property shall be the same as the basis of the stock exchanged therefor, adjusted for—

(i) The transfer of assets within the affiliated group by the distributing corporation (by sale, gift, or otherwise) without consideration or at markedly fictitious values, during the period for which the corporations were affiliated (whether or not a consolidated return was made);

(ii) Distribution during a consolidated return period of earnings or profits accumulated prior to the date upon which the distributing corporation became a member of the group;

(iii) Cash received in the distribution; and

(iv) The amount of gain recognized to the distributee in the liquidation.

(d) *Basis not affected by acquisition or sale of stock.* Neither the acquisition of stock of a corporation nor its sale or other disposition shall affect the basis of the property of such corporation for determining gain or loss or upon which exhaustion, wear and tear, obsolescence, amortization, and depletion are to be allowed.

§ 1.1502–39 Inventories.

(a) *Consolidated return for first year of affiliation.* If the income of an affiliated corporation is included in a consolidated return for the period immediately following the date upon which such corporation became a member of the affiliated group, the value of its opening inventory to be used in computing the consolidated taxable income shall be the proper value of the closing inventory used in computing its taxable income for the preceding taxable year.

(b) *Consolidated return after separate return by affiliates.* If—

(1) A corporation which is a member of the affiliated group for the first consolidated return period was a member of the group in the preceding taxable year, or

(2) A corporation which filed a separate return for its previous taxable year was not a member of the affiliated group within the meaning of section 141 of the Internal Revenue Code of 1939, at any time during the last taxable year of the group not subject to section 1502, but which would have been a member of the group during such period if section 1504 had been applicable and is a member of the affiliated group filing a consolidated return for the first taxable year to which section 1502 is applicable,

the value of its opening inventory to be used in computing the consolidated taxable income for the first consolidated return period shall be the proper value of the closing inventory used in computing its taxable income for the preceding taxable year, decreased in the amount of profits or increased in the amount of losses reflected in such inventories which arose in transactions between members of the affiliated group and which have not been realized by the group through final transactions with persons other than members of the group.

(c) *Separate returns made after consolidated returns.* If a corporation which was a member of an affiliated group in a consolidated return period makes or is required to make a separate return for the succeeding taxable year, the value of its opening inventory to be used in computing its taxable income for such succeeding taxable year shall be the proper value of its closing inventory used in computing consolidated taxable income for the last consolidated return period increased in the amount of profits or decreased in the amount of losses eliminated in the computation of such inventory as profits or losses arising in transactions between members of the affiliated group, but in an amount not exceeding, in the case of profits, either the amount of profits arising from such intercompany transactions reflected in the closing inventory of such corporation for such succeeding taxable year or the amount of such intercompany profits eliminated from its opening inventory for its first consolidated return period pursuant to the provisions of paragraph (b) of this section, and not exceeding, in the case of losses, either the amount of losses arising from intercompany transactions reflected in the closing inventory for such corporation for such succeeding taxable year or the amount of such intercompany losses eliminated from its opening inventory for its first consolidated return period pursuant to the provisions of paragraph (b) of this section.

§ 1.1502–40 Bad debts.

(a) *Deduction during consolidated return period.* No deduction shall be allower during a consolidated return period to any member of the affiliated group on account of worthlessness in whole or in part of any obligation (including accounts receivable, bonds, notes, debts, and claims of whatsoever nature) of any other corporation which was a member of the group as of the last day of the taxable year or which was liquidated by the group during such year, except as a loss resulting from a bona fide termination of the business and operations of such other corporation, whether in liquidation or otherwise, in which case the loss shall be computed subject to the adjustments specified in § 1.1502–35 and the provisions of § 1.1502–36 shall be applicable.

(b) *Limitation of allowance after consolidated return period.* With respect to obligations (including accounts receivable) of a member of an affiliated group acquired in any way by another member of the group prior to or during any taxable year subsequent to 1928 for which a consolidated income or excess profits tax return was filed, the adjustments prescribed with respect to the allowance of losses upon the sale of bonds shall be applicable to the allowance of any bad debt deduction for any period subsequent to the consolidated return period. See § 1.1502–35.

§ 1.1502–41 Sale and retirement by corporation of its bonds.

(a) *Issued at discount or premium.* If a corporation which during any taxable year has been a member of an affiliated group which makes or is required to make a consolidated return, has issued its bonds at a discount or premium (whether or not during a consolidated return period), deduction will be allowed for the amortization of the discount, and income included for the amortization of the premium, in the same manner, to the same extent, and upon the same conditions as if the corporation had never been affiliated, except that no deduction for amortization of discount shall be allowed, and no income shall be included for amortization of premium, during a period for which a consolidated return is made, on bonds of one member of the group owned by another member of the group.

(b) *Acquisition of bonds by issuing company.* If a corporation which has been a member of an affiliated group which makes or is required to make a consolidated return, acquires its bonds (whether or not from another member of such group and whether or not during a consolidated return period), gain or loss shall be recognized in the same manner to the same extent and upon the same conditions as if the corporation had never been affiliated, except that, if such bonds are acquired from another member of the group during a consolidated return period, and in a transaction other than a distribution in a liquidation in which gain or loss to the distributee is recognized pursuant to paragraph (a) of § 1.1502–37 in determining the gain or loss to the issuing company from such acquisition, the basis thereof to such other member of the group shall be deemed the purchase price.

§ 1.1502–42 Capital loss limitations and carryover.

(a) The provisions of sections 165, 832(c)(5), 1211, 1212, and 1231 with respect to gains and losses from sales or exchanges of capital assets shall be applied, in respect of such gains and losses sustained during a consolidated return period as if the affiliated group were the taxpayer.

(b) With respect to a net capital loss sustained by a corporation in a taxable year prior to the first consolidated return period in respect of which its income is included in a consolidated return, such loss (in an amount not in excess of the net capital gain of such corporation for succeeding consolidated return periods) shall, for the purposes of section 1212, relating to net capital loss carryovers, be treated as if such net capital loss had been sustained by the affiliated group.

(c) A consolidated net capital loss of an affiliated group for a consolidated return period shall be considered as a consolidated short-term capital loss in subsequent consolidated return periods notwithstanding that one or more corporations, members of the group in the taxable year in which such loss was sustained, make separate returns for subsequent taxable years (or join in a consolidated return made by another affiliated group), but only to the extent

that such consolidated net capital loss is not attributable to such corporations; and such portion of such consolidated net capital loss as is attributable to the several corporations making separate returns (or joining in a consolidated return made by another affiliated group) for a subsequent taxable year shall be considered as a short-term capital loss in such separate returns, or in such consolidated return of the other affiliated group, but only to the extent that such portion of such consolidated net capital loss was not absorbed in intervening taxable years by net capital gains, consolidated or separate, as the case may be. Any net capital loss sustained by a corporation prior to the first taxable year in respect of which its income is included in the consolidated return shall be considered as a short-term capital loss in the separate return of such corporation (or the consolidated return of another affiliated group of which it becomes a member) for a subsequent taxable year for which it makes a separate return or joins in a consolidated return of another group, but only to the extent that such net capital loss was not absorbed in intervening taxable years by net capital gains, consolidated or separate, as the case may be.

§ 1.1502–43 Credit for foreign taxes.

(a) *Choice of credit or deduction.* The credit under section 901 for taxes paid or accrued to any foreign country or possession of the United States shall be allowed to an affiliated group filing a consolidated return only if the common parent corporation chooses to use such credit in the computation of the tax liability of the group for the taxable year. If this choice is made, no deduction may be taken under section 164 on the consolidated return for such taxes paid or accrued by any member of the group. For purposes of this section, the term "taxes paid or accrued to any foreign country or possession of the United States" includes the amount of taxes deemed paid pursuant to section 902.

(b) *Amount of credit.* Subject to the limitation provided in paragraph (c) of this section, the credit allowable to an affiliated group filing a consolidated return shall be an amount equal to the aggregate of the taxes paid or accrued to any foreign country or possession by the several members of the affiliated group for the taxable year, plus the aggregate of the consolidated excess tax paid carryovers and carrybacks to the taxable year allowable as a credit under section 904(c).

(c) *Per country limitation.* The credit for tax paid or accrued for the taxable year to any country or possession shall not exceed an amount which bears the same ratio to the total tax of the affiliated group against which the credit is taken as the consolidated taxable income of the group from sources within such country or possession (but not in excess of the consolidated taxable income of the group) bears to the entire consolidated taxable income.

(d) *Consolidated excess tax paid carryovers.* The consolidated excess tax paid carryovers to the current taxable year for taxes paid to any foreign country or possession shall consist of—

(1) The consolidated excess tax paid to such country or possession for the five preceding taxable years (not including as a preceding taxable year any taxable year beginning before January 1, 1958) to the extent that the consolidated excess tax paid for any such preceding taxable year was not attributable to a corporation making a separate return or joining in a consolidated return filed by another affiliated group for the current taxable year and was not absorbed pursuant to section 904(c) in years preceding the current taxable year (whether or not taken as a credit), and,

with respect to the excess tax paid by a corporation in a taxable year for which a separate return was filed, or for which such corporation joined in a consolidated return filed by another affiliated group, but subject to the limitation prescribed in paragraph (h) of this section—

(2) The amount of the excess tax paid to such country or possession by such corporation for the five preceding taxable years (not including as a preceding taxable year any taxable year beginning before January 1, 1958) to the extent that the excess tax paid for any such preceding taxable year was not absorbed pursuant to section 904(c) in years preceding the current taxable year (whether or not taken as a credit).

(e) *Consolidated excess tax paid carrybacks.* (1) The consolidated excess tax paid carrybacks to the current taxable year for taxes paid to any foreign country or possession shall consist of—

(i) The consolidated excess tax paid to such country or possession for the first succeeding taxable year (to the extent not attributable to a corporation making a separate return or joining in a consolidated return filed by another affiliated group for the current taxable year) reduced to the extent absorbed pursuant to section 904(c) in the first preceding taxable year (whether or not taken as a credit), and

(ii) The consolidated excess tax paid to such country or possession for the second succeeding taxable year to the extent not attributable to a corporation making a separate return or joining in a consolidated return filed by another affiliated group for the current taxable year;

and, with respect to any excess tax paid to such country or possession by a corporation which for either of the two succeeding taxable years files a separate return or joins in a consolidated return filed by another affiliated group, but subject to the limitation prescribed in paragraph (h) of this section—

(iii) The amount of such excess tax paid by such corporation for the first succeeding taxable year reduced to the extent absorbed pursuant to section 904(c) by such corporation for the first preceding taxable year (whether or not taken as a credit), or if the income of such corporation is included in a consolidated return for the first preceding taxable year, reduced to the extent absorbed pursuant to section 904(c) by such consolidated return (whether or not taken as a credit); and

(iv) The amount of such excess tax paid by such corporation for the second succeeding taxable year.

(2) The excess tax paid, whether consolidated or separate, may not be carried back to a taxable year beginning before January 1, 1958; and in determining the carryover or carryback to taxable years beginning on or after January 1, 1958, no amount shall be treated as absorbed for taxable years beginning before such date.

(f) *Consolidated excess tax paid.* The consolidated excess tax paid to any foreign country or any possession for a taxable year is the excess of the aggregate of the taxes paid or accrued by the several members of the affiliated group to such country or possession over the per country limitation described in paragraph (c) of this section applicable to such country or possession. However, there is no consolidated excess tax paid for a taxable year in which the affiliated group takes any deduction under section 164 for such taxes paid or accrued to a foreign country or possession.

(g) *Excess tax paid.* The excess tax paid or accrued to any foreign country or possession by a corporation for any year for which a separate return is filed is the excess of the taxes paid or accrued by the corporation to such foreign country or possession over the amount allowable as a credit for such year pursuant to section 904(a). However, there is no such excess tax paid or accrued for a taxable year in which the corporation takes a deduction under section 164 for such taxes paid to any foreign country or possession.

(h) *Limitation on credit for carryovers and carrybacks of excess tax paid from separate return years.* In no case shall there be included in the credit for taxes paid or accrued to any foreign country or possession for the taxable year as consolidated excess tax paid carryovers under paragraph (d)(2) of this section (relating to excess tax paid by a corporation in years for which separate returns were filed, or for which such corporation joined in a consolidated return filed by another affiliated group), and as consolidated excess tax paid carrybacks under paragraph (e)(1)(iii) and (iv) of this section (relating to excess tax paid by a corporation which for either of the two succeeding taxable years files a separate return or joins in a consolidated return filed by another affiliated group), an amount exceeding in the aggregate that which would be allowable as a credit for a carryover or carryback to such corporation if it had filed a separate return for such taxable year.

(i) *Apportionment of consolidated excess tax paid.* If an affiliated group filing a consolidated return has a consolidated excess tax paid with respect to any foreign country or any possession for the taxable year and if there are included as members of such group one or more corporations which make separate returns (or join in a consolidated return filed by another affiliated group) in a preceding or succeeding taxable year, the portion of such consolidated excess tax paid attributable to such corporations severally shall be determined. The portion in the

case of any such corporation shall be the amount which bears the same ratio to such consolidated excess tax paid as the tax paid or accrued by such corporation to such country or possession bears to the total tax paid or accrued by the affiliated group to such country or possession.

(j) *Consolidated excess tax paid before or after consolidated return period.* The consolidated excess tax paid by an affiliated group with respect to any foreign country or possession shall be used in computing the consolidated excess tax paid carryover and carryback of the group notwithstanding that one or more corporations that were members of the group in the taxable year in which such consolidated excess tax paid originates make separate returns (or join in a consolidated return made by another affiliated group) for a subsequent taxable year (or in the case of a carryback for a preceding taxable year) but only to the extent that such consolidated excess tax paid is not attributable to such corporation. Such portion of such consolidated excess tax paid as is attributable to the several corporations making separate returns (or joining in a consolidated return made by another affiliated group) for a subsequent taxable year (or in the case of a carryback, for a preceding taxable year) reduced to the extent absorbed in earlier years shall be used by such corporations severally as carryovers or as carrybacks in such separate returns or in such consolidated returns of the other affiliated group. Any excess tax paid by a corporation prior to the first taxable year in which its income is included in the consolidated return of the group (or paid in either of the two years immediately following a consolidated return year) may be used in computing the carryover or carryback of such corporation (or of another affiliated group of which it becomes a member) for a subsequent taxable year for which it makes a separate return or joins in the consolidated return of another group, but only to the extent that such excess tax paid was not absorbed (either as a carryover or as a carryback) for consolidated return periods.

§ 1.1502–44 Methods of accounting.

(a) *In general.* All members of the affiliated group shall adopt that method of accounting which clearly reflects the consolidated taxable income. A method of accounting which does not treat with reasonable consistency all items of gross income and deductions of the various members of the group shall not be regarded as clearly reflecting the consolidated taxable income. For example, one member of the group will not be permitted to report items of income or deductions on the cash method of accounting while another member of the same group reports the same or similar items on the accrual method. The provisions of this paragraph are subject to the exceptions stated in paragraph (b) of this section.

(b) *Combination of methods.* If the members of an affiliated group have established different methods of accounting, each member may retain such method with the consent of the Commissioner: *Provided,* That the consolidated taxable income is clearly reflected: *And provided further,* That intercompany transactions affecting such consolidated taxable income shall be eliminated and adjustments on account of such transactions shall be made with reference to a uniform method of accounting to be selected by the members of the group with the consent of the Commissioner.

(c) *Adjustments required by changes in method of accounting.* In any case in which a member of an affiliated group changes its method of accounting the provisions of section 481 (a) shall be applicable.

§ 1.1502–45 Mine exploration expenditures.

For the purpose of applying the limitation provided in section 615 (c) (whether during a consolidated return period or during a period for which a separate return is made), if during a preceding taxable year for which a consolidated return was made or was required to be made any member of the affiliated group for such preceding taxable year was allowed the deduction provided in section 615 (a) or made the election provided in section 615 (b), each member of the affiliated group for such preceding taxable year shall be deemed to have been allowed such deduction or to have made such election, as the case may be.

§ 1.1502–46 Depreciation.

In the computation of the deduction for depreciation under section 167, property received by one member of the group from another member of the group during a consolidated return period, shall be treated in the same manner as it could be treated if it were held by the transferor.

§ 1.1502–47 Election to deduct accrued taxes.

If all members of the affiliated group were taxpayers which, for each taxable year in which they were subject to the tax imposed by section 500 of the Internal Revenue Code of 1939 deducted Federal income and excess profits taxes when paid for the purpose of computing subchapter A net income under such Code, the affiliated group shall, if the tax liability under section 541 is computed upon the consolidated undistributed personal holding company income, deduct taxes under section 545 when paid unless a member of the common affiliated group elects in its return or the common parent elects in a consolidated return for the group of which it is the common parent for a taxable year ending after June 30, 1954, to deduct the taxes described in section 545, when accrued. In any case in which the common parent corporation or any member of the affiliated group has, prior to the taxable year, elected to deduct such taxes when accrued, each member of the group shall be deemed to have so elected in the first year thereafter in which its income is included in the consolidated personal holding company income. If an election is made by the common parent corporation with respect to a year for which the tax liability under section 541 is computed upon the consolidated undistributed personal holding company income, each member of the group shall be deemed to have made such election in such year. Any such election made or deemed to have been made shall be applicable to each member of the group for the taxable year for which the election is made and for all subsequent taxable years. Any election so made shall be irrevocable.

§ 1.1502–48 Liability for tax under section 531.

In any case in which an affiliated group computes the tax liability under section 541, upon the consolidated undistributed personal holding company income, the tax imposed by section 531 shall not be applicable.

§ 1.1502–49 Additions to tax for failure to pay estimated tax.

(a) Except in the case of an affiliated group described in paragraph (b) of this section, any addition to the tax under section 6655 for underpayment of estimated tax of a member of an affiliated group which files a consolidated return for the taxable year shall be determined by allocating the tax shown on the consolidated return to the several members of the group by any of the methods provided in paragraph (a) of § 1.1552–1 selected by the common parent corporation for the taxable year, without regard to the method elected under section 1552. If the group would use the method of allocation authorized by paragraph (a)(4) of § 1.1552–1, it must be the method elected by the group with the approval of the Commissioner for the purpose of determining earnings and profits. In the application of section 6655 (d) (1) with respect to a member of the group which was included in a consolidated return for the preceding taxable year, whether or not such member is included in a consolidated return for the taxable year, the "tax shown on the return" for the preceding taxable year shall be the portion of the tax shown on such consolidated return determined by allocating such tax to the several members of the group by the procedure described above. In the application of section 6655 (d) (2) if the corporation was included in a consolidated return for the preceding taxable year, the "facts shown on the return" shall be the facts shown on the consolidated return of the group (whether of this or another affiliated group) for the preceding taxable year attributable to such corporation.

(b) In the case of an affiliated group which has filed pursuant to the provisions of paragraph (c)(2) of § 1.1502–10 a declaration of estimated tax for the taxable year for which a consolidated return is filed, any addition to the tax provided by section 6655 shall be determined by reference to the payments made on such declaration and to the tax shown on the consolidated return.

(c) In the application of section 6655 (d) (1) with respect to the affiliated group described in paragraph (b) of this section, the "tax shown on the return" shall be—

(1) If the group filed a consolidated return for the preceding taxable year, the tax shown on such return, or

(2) If the group did not file a consolidated return for the preceding taxable year, the aggregate of the taxes of the several members of the group shown on any separate returns of such corporations for the preceding taxable year, plus the tax shown on a consolidated return for the preceding taxable year attributable to any member of the group which joined in a consolidated return with another affiliated group for such preceding taxable year. The tax attributable to any such corporation which joined in a consolidated return shall be determined by allocating the tax shown on such consolidated return in accordance with the procedure described in paragraph (a) of this section.

(d) In the application of section 6655 (d) (2) with respect to the affiliated group described in paragraph (b) of this section, the "facts shown on the return" shall be—

(1) If the group filed a consolidated return for the preceding taxable year, the facts shown on such return, or

(2) If the group did not file a consolidated return for the preceding taxable year, the facts shown on the separate returns of the members of the affiliated group for the preceding taxable year together with the facts shown on a consolidated return for the preceding taxable year attributable to any member of the group which joined in a consolidated return with another affiliated group for such preceding taxable year.

§ 1.1502–50 Gain on sale of bonds and other evidences of indebtedness.

In the application of section 1232(a), if one member of the affiliated group acquires a bond or other evidence of indebtedness from another member of the affiliated group during a consolidated return period, the determination of the amount which is treated as gain from the sale or exchange of property which is not a capital asset shall be made by including in the period of time during which such bond or other evidence of indebtedness was held, the period of time during which it was held by any other corporation which transferred it in a transaction to which paragraph (b)(1)(i) of § 1.1502–31 (or the corresponding provision of prior consolidated returns regulations) is applicable without regard to any period of time before the last sale or exchange of such instrument to which such section is not applicable. In the application of section 1232(c), if a bond or other evidence of indebtedness was acquired from another member of an affiliated group during a consolidated return period, then the bond or other evidence of indebtedness shall be deemed to have been purchased at the time of, and as having a market value with coupons attached, determined by reference to the earliest date of purchase by any other corporation which transferred it in a transaction to which paragraph (b)(1)(i) of § 1.1502–31 (or the corresponding provision of prior consolidated returns regulations) is applicable without regard to any purchase prior to the last purchase to which such section is not applicable.

§ 1.1503 Statutory provisions; computation and payment of tax.

SEC. 1503. *Computation and payment of tax*—(a) *General rule.* In any case in which a consolidated return is made or is required to be made, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502 prescribed prior to the last day prescribed by law for the filing of such return; except that the tax imposed under section 11 (c) or section 831 shall be increased for any taxable year by 2 percent of the consolidated taxable income of the affiliated group of includible corporations. For purposes of this section, the term "consolidated taxable income" means the consolidated taxable income computed without regard to the deduction provided by section 242 for partially tax-exempt interest.

(b) *Limitation.* If the affiliated group includes one or more Western Hemisphere trade corporations (as defined in section 921) or one or more regulated public utilities (as defined in subsection (c)), the increase of 2 percent provided in subsection (a) shall be applied only on the amount by which the consolidated taxable income of the affiliated group exceeds the portion (if any) of the consolidated taxable income attributable to the Western Hemisphere trade corporations and regulated public utilities included in such group.

(c) *Regulated public utility defined*—(1) *In general.* For purposes of subsection (b), the term "regulated public utility" means—

(A) A corporation engaged in the furnishing or sale of—

(i) Electric energy, gas, water, or sewerage disposal services, or

(ii) Transportation (not included in subparagraph (C)) on an intrastate, suburban, municipal, or interurban electric railroad, on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system, or

(iii) Transportation (not included in clause (ii)) by motor vehicle—

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

(B) A corporation engaged as a common carrier in the furnishing or sale of transportation of gas by pipeline, if subject to the jurisdiction of the Federal Power Commission.

(C) A corporation engaged as a common carrier (i) in the furnishing or sale of transportation by railroad, if subject to the jurisdiction of the Interstate Commerce Commission, or (ii) in the furnishing or sale of transportation of oil or other petroleum products (including shale oil) by pipe line, if subject to the jurisdiction of the Interstate Commerce Commission or if the rates for such furnishing or sale are subject to the jurisdiction of a public service or public utility commission or other similar body of the District of Columbia or of any State.

(D) A corporation engaged in the furnishing or sale of telephone or telegraph service, if the rates for such furnishing or sale meet the requirements of subparagraph (A).

(E) A corporation engaged in the furnishing or sale of transportation as a common carrier by air, subject to the jurisdiction of the Civil Aeronautics Board.

(F) A corporation engaged in the furnishing or sale of transportation by common carrier by water, subject to the jurisdiction of the Interstate Commerce Commission under part III of the Interstate Commerce Act, or subject to the jurisdiction of the Federal Maritime Board under the Intercoastal Shipping Act, 1933.

(2) *Limitation.* For purposes of subsection (b), the term "regulated public utility" does not (except as provided in paragraph (3)) include a corporation described in paragraph (1) unless 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from sources described in paragraph (1). If the taxpayer establishes to the satisfaction of the Secretary or his delegate that—

(A) Its revenue from regulated rates described in paragraph (1) (A) or (D) and its revenue derived from unregulated rates are derived from its operation of a single interconnected and coordinated system or from the operation of more than one such system, and

(B) The unregulated rates have been and are substantially as favorable to users and consumers as are the regulated rates,

such revenue from such unregulated rates shall be considered, for purposes of this paragraph, as income derived from sources described in paragraph (1) (A) or (D).

(3) *Certain railroad corporations*—(A) *Lessor corporation.* For purposes of subsection (b), the term "regulated public utility" shall also include a railroad corporation subject to part I of the Interstate Commerce Act, if (i) substantially all of its railroad properties have been leased to another such railroad corporation or corporations by an agreement or agreements entered into prior to January 1, 1954, (ii) each lease is for a term of more than 20 years, and (iii) at least 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from such leases and from sources described in paragraph (1). For purposes of the preceding sentence, an agreement for lease of railroad properties entered into prior to January 1, 1954, shall be considered to be a lease including such term as the total number of years of such agreement may, unless sooner terminated, be renewed or continued under the terms of the agreement, and any such renewal or continuance under such agreement shall be considered part of the lease entered into prior to January 1, 1954.

(B) *Common parent corporation.* For purposes of subsection (b), the term "regulated public utility" also includes a common parent corporation which is a common carrier by railroad subject to part I of the Interstate Commerce Act if at least 80 percent of its gross income (computed without regard to capital gains or losses) is derived directly or indirectly from sources described in paragraph (1). For purposes of the preceding sentence, dividends and interest, and income from leases described in subparagraph (A), received from a regulated public utility shall be considered as derived from sources described in paragraph (1) if the regulated public utility is a member of an affiliated group (as defined in section 1504) which includes the common parent corporation.

§ 1.1503–1 Computation and payment of tax.

(a) *General rule.* In any case in which a consolidated return is filed or required to be filed, the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations prescribed under section 1502 promulgated prior to the last date prescribed by law for the filing of such return.

(b) *Limitation.* If the affiliated group includes one or more Western Hem-

isphere trade corporations (as defined in section 921) or one or more regulated public utilities (as defined in section 1503 (c)), the increase in tax described in section 1503 (a) shall be applied in a manner provided in the regulations under section 1502.

(c) *Regulated public utilities.* For regulations relating to the definition of "regulated public utility", see paragraph (g) of § 1.1502–2.

§ 1.1504 Statutory provisions; definitions.

SEC. 1504. *Definitions*—(a) *Definition of "affiliated group."* As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(b) *Definition of "includible corporation".* As used in this chapter, the term "includible corporation" means any corporation except—

(1) Corporations exempt from taxation under section 501.

(2) Insurance companies subject to taxation under section 802 or 821.

(3) Foreign corporations.

(4) Corporations entitled to the benefits of section 931, by reason of receiving a large percentage of their income from sources within possessions of the United States.

(5) Corporations organized under the China Trade Act, 1922.

(6) Regulated investment companies subject to tax under subchapter M of chapter 1.

(7) Unincorporated business enterprises subject to tax as corporations under section 1361.

(c) *Includible insurance companies.* Despite the provisions of paragraph (2) of subsection (b), two or more domestic insurance companies each of which is subject to taxation under the same section of this subtitle shall be considered as includible corporations for the purpose of the application of subsection (a) to such insurance companies alone.

(d) *Subsidiary formed to comply with foreign law.* In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subtitle as a domestic corporation.

[Sec. 1504 as amended by sec. 5, Act of March 13, 1956 (Pub. Law 429, 84th Cong., 70 Stat. 49); sec. 64(d)(3), Technical Amendments Act 1958 (72 Stat. 1657); sec. 3(f)(1), Life Insurance Company Income Tax Act 1959 (73 Stat. 140); sec. 2(c), Act of Sept. 23, 1959 (Pub. Law 86-376, 73 Stat. 699)]

§ 1.1504–1 Definitions.

The privilege of filing consolidated returns is extended to all includible corporations constituting affiliated groups as defined in section 1504. See the regulations under § 1.1502 for a description of an affiliated group and the corporations which may be considered as includible corporations.

§ 1.1505 Statutory provisions; cross references.

SEC. 1505. *Cross references.* (1) For suspension of running of statute of limitations when notice in respect of a deficiency is mailed to one corporation, see section 6503 (a) (1).

(2) For allocation of income and deductions of related trades or businesses, see section 482.

RELATED RULES

§ 1.1551 Statutory provision; disallowance of surtax exemption and accumulated earnings credit.

SEC. 1551. *Disallowance of surtax exemption and accumulated earnings credit.* If any corporation transfers, on or after January 1, 1951, all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year (except as may be otherwise determined under section 269(b)) be allowed either the $25,000 exemption from surtax provided in section 11(c) or the $100,000 accumulated earnings credit provided in paragraph (2) or (3) of section 535(c), unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. For purposes of this section, control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of the corporation. In determining the ownership of stock for the purpose of this section, the ownership of stock shall be determined in accordance with the provisions of section 544, except that constructive ownership under section 544(a)(2) shall be determined only with respect to the individual's spouse and minor children. The provisions of section 269(b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with the provisions of this section, be applicable to this section.

[Sec. 1551 as amended by sec. 205(a), Small Business Tax Revision Act 1958 (72 Stat. 1680)]

§ 1.1551–1 Disallowance of surtax exemption and accumulated earnings credit.

(a) *In general.* If one corporation transfers on or after January 1, 1951, all or part of its property (other than money) to another corporation, neither the $25,000 exemption from surtax provided in section 11(c) nor the $100,000 ($60,000 if the taxable year begins before January 1, 1958) accumulated earnings credit provided in paragraph (2) or (3) of section 535(c) shall be allowed the transferee if:

(1) The transferee was created for the purpose of acquiring such property, or

(2) The transferee was not actively engaged in business at the time of the acquisition, and

(3) After such transfer, the transferor or its stockholders, or both, are in control of the transferee during any part of the taxable year of the transferee, unless,

(4) The transferee establishes by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not a major purpose of such transfer, or

(5) The Commissioner allows such exemption or credit pursuant to the authority provided in section 1551 and section 269 (b).

(b) *Purpose of section 1551.* (1) The purpose of section 1551 is to prevent avoidance or evasion of the surtax imposed by section 11 (c) or of the accumulated earnings tax imposed by section 531. It is not intended, however, that section 1551 be interpreted as delimiting or abrogating any principle of law established by judicial decision, or any existing provisions of the Code, such as sections 269 and 482, which have the effect of preventing the avoidance or evasion of income taxes. Such principles of law and such provisions of the Code, including section 1551, are not mutually exclusive, and in appropriate cases they may operate together or they may operate separately.

(2) The provisions of section 269 (b) and the authority of the Commissioner thereunder, to the extent not inconsistent with the provisions of section 1551 are applicable to cases covered by section 1551. Pursuant to the authority provided in section 269 (b) the Commissioner may allow to the transferee any part of a surtax exemption or accumulated earnings credit for a taxable year for which such exemption or credit would otherwise be disallowed under section 1551; or he may apportion such exemption or credit among the corporations involved. For example, Corporation A transfers on January 1, 1955, all its property to Corporations B and C in exchange for all the stock of such corporations. Immediately thereafter, Corporation A is dissolved and its stockholders become the sole stockholders of Corporations B and C. Assuming that Corporations B and C are unable to establish by the clear preponderance of the evidence that the securing of the surtax exemption provided in section 11 (c) or the accumulated earnings credit provided in section 535 or both, was not a major purpose of the transfer, the Commissioner, nevertheless, has authority under sections 1551 and 269 (b) to allow one such exemption and credit and to apportion such exemption and credit between Corporations B and C.

(3) For the purpose of section 1551 and this section, a corporation maintaining an office for the purpose of preserving its corporate existence is not considered to be "actively engaged in business" even though such corporation may be deemed to be "doing business" for other purposes. Similarly, for the purpose of section 1551 and this section, a corporation engaged in winding up its affairs, prior to an acquisition to which section 1551 is applicable, is not considered to be "actively engaged in business."

(c) *Meaning and application of the term "control."* (1) For the purpose of section 1551 and this section, the term "control" means the ownership of stock possessing either (i) at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or (ii) at least 80 percent of the total value of shares of all classes of stock of the corporation. In determining whether stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote is owned, all classes of such stock shall be considered together; it is not necessary that 80 percent of each class of voting stock be owned. Likewise, in determining whether stock possessing at least 80 percent of the total value of shares of all classes of stock is owned, all classes of stock of the corporation shall be considered together; it is not necessary that 80 percent of the value of shares of each class be owned. The fair market value of a share shall be considered as the value to be used for the purpose of this computation. The ownership of stock shall be determined in accordance with the provisions of section 544 and the regulations thereunder, except that constructive ownership under section 544 (a) (2) shall be determined only with respect to the individual's spouse and minor children. For example, in addition to stock held directly or under an option to purchase, an individual is deemed to own stock held directly or indirectly by or for his spouse or minor children, and also to own a proportionate part of the stock owned by a corporation, partnership, estate, or trust in which he holds an interest as a shareholder, partner, or beneficiary.

(2) Disallowance of the exemption and credit under section 1551 is not limited to the taxable year of the transferee corporation in which the transfer of property occurs. Section 1551 provides for the disallowance of the exemption and credit for any taxable year whether the taxable year in which the transfer of property occurs or any subsequent taxable year of the transferee corporation, if, during any part of such year, the transferor corporation or its stockholders, or both, are in control of the transferee corporation. Thus, if Corporation D on January 1, 1955, transfers a part of its property to Corporation E, a corporation not actively engaged in business at the time of the acquisition of such property, in exchange for 60 percent of the voting stock of Corporation E, and, thereafter, during a later taxable year with respect to which section 1551 is applicable, acquires an additional 20 percent of the voting stock of Corporation E, Corporation D, by reason of such later acquisition, is considered to be in control of Corporation E as of the time of such acquisition for the purpose of section 1551. Accordingly, Corporation E will be disallowed the surtax exemption and accumulated earnings credit for the taxable year in which the later acquisition of stock occurred and for each taxable year thereafter in which the requisite control continues, unless Corporation E establishes by the clear preponderance of the evidence that the securing of such exemption or credit, or both, was not a major purpose of the transfer of the property in 1955.

(3) In determining, for the purpose of section 1551 whether a corporation, its stockholders, or both, are in control of a transferee corporation, it is not necessary that the stock be acquired on or after January 1, 1951. Thus, if Corporation F on June 1, 1950, owns 70 percent of the voting stock of Corporation G, and, thereafter, on January 2, 1955, Corporation F acquires an additional 10 percent of such stock, control within the meaning of section 1551 is acquired by Corporation F on January 2, 1955.

(d) *Nature of transfer.* A transfer made by any corporation of all or part of its assets, whether or not such transfer qualifies as a reorganization under section 368 is within the scope of section 1551 except that section 1551 does not apply to a transfer of money only. For example, the transfer of cash for the purpose of expanding the business of the transferor corporation through the formation of a new corporation is not a transfer within the scope of section 1551 irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property.

(e) *Purpose of transfer.* In determining, for the purpose of section 1551, whether the securing of the exemption from surtax or the accumulated earnings credit constituted "a major purpose" of the transfer, all circumstances relevant to the transfer shall be considered. For disallowance of the surtax exemption and accumulated earnings credit under section 1551, it is not necessary that the obtaining of either such credit or exemption or both have been the sole or principal purpose of the transfer of the property. It is sufficient if it appears, in the light of all the facts and circumstances, that the obtaining of such exemption or credit, or both, was one of the major considerations that prompted the transfer. Thus, the securing of the surtax exemption or the accumulated earnings credit may constitute "a major purpose" of the transfer, notwithstanding that such transfer was effected for a valid business purpose and qualified as a reorganization within the meaning of section 368. The taxpayer's burden of establishing by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not "a major purpose" of the transfer may be met, for example, by a showing that the obtaining of such exemption, or credit, or both, was not a major factor in relationship to the other consideration or considerations which prompted the transfer.

§ 1.1552 Statutory provisions; earnings and profits.

SEC. 1552. *Earnings and profits.*—(a) *General rule.*—Pursuant to regulations prescribed by the Secretary or his delegate the earnings and profits of each member of an affiliated group required to be included in a consolidated return for such group filed for a taxable year beginning after December 31, 1953, and ending after the date of enactment of this title, shall be determined by allocating the tax liability of the group for such year among the members of the group in accord with whichever of the following methods the group shall elect in its first consolidated return filed for such a taxable year:

(1) The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income.

(2) The tax liability of the group shall be allocated to the several members of the group on the basis of the percentage of the total tax which the tax of such member if computed on a separate return would bear to the total amount of the taxes for all members of the group so computed.

(3) The tax liability of the group (excluding the tax increases arising from the consolidation) shall be allocated on the basis of the contribution of each member of the group to the consolidated taxable income of the group. Any tax increases arising from the consolidation shall be distributed to the several members in direct proportion to the reduction in tax liability resulting to such members from the filing of the consolidated return as measured by the difference between their tax liabilities determined on a separate return basis and their tax liabilities (determined without regard to the 2 percent increase provided by section 1503 (a)) based on their contributions to the consolidated taxable income.

(4) The tax liability of the group shall be allocated in accord with any other method selected by the group with the approval of the Secretary or his delegate.

(b) *Failure to elect.* If no election is made in such first return, the tax liability shall be allocated among the several members of the group pursuant to the method prescribed in subsection (a) (1).

§ 1.1552–1 Earnings and profits.

(a) *General rule.* For the purpose of determining the earnings and profits of each member of an affiliated group which is required to be included in a consolidated return for such group filed for a taxable year beginning after December 31, 1953, and ending after August 16, 1954, the tax liability of the group shall be allocated among the members of the group in accordance with whichever of the following methods the group shall elect in its first consolidated return for such a taxable year:

(1) The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income.

(2) The tax liability of the group shall be allocated to the several members of the group on the basis of the percentage of the total tax which the tax of such member if computed on a separate return would bear to the total amount of the taxes for all members of the group so computed.

(3) The tax liability of the group (excluding the tax increases arising from the consolidation) shall be allocated on the basis of the contribution of each member of the group to the consolidated taxable income of the group. Any tax increases arising from the consolidation shall be distributed to the several members in direct proportion to the reduction in tax liability resulting to such members from the filing of the consoli-

isphere trade corporations (as defined in section 921) or one or more regulated public utilities (as defined in section 1503 (c)), the increase in tax described in section 1503 (a) shall be applied in a manner provided in the regulations under section 1502.

(c) *Regulated public utilities.* For regulations relating to the definition of "regulated public utility", see paragraph (g) of § 1.1502–2.

§ 1.1504 Statutory provisions; definitions.

SEC. 1504. *Definitions*—(a) *Definition of "affiliated group."* As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

(b) *Definition of "includible corporation".* As used in this chapter, the term "includible corporation" means any corporation except—

(1) Corporations exempt from taxation under section 501.

(2) Insurance companies subject to taxation under section 802 or 821.

(3) Foreign corporations.

(4) Corporations entitled to the benefits of section 931, by reason of receiving a large percentage of their income from sources within possessions of the United States.

(5) Corporations organized under the China Trade Act, 1922.

(6) Regulated investment companies subject to tax under subchapter M of chapter 1.

(7) Unincorporated business enterprises subject to tax as corporations under section 1361.

(c) *Includible insurance companies.* Despite the provisions of paragraph (2) of subsection (b), two or more domestic insurance companies each of which is subject to taxation under the same section of this subtitle shall be considered as includible corporations for the purpose of the application of subsection (a) to such insurance companies alone.

(d) *Subsidiary formed to comply with foreign law.* In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors' qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subtitle as a domestic corporation.

[Sec. 1504 as amended by sec. 5, Act of March 13, 1956 (Pub. Law 429, 84th Cong., 70 Stat. 49); sec. 64(d)(3), Technical Amendments Act 1958 (72 Stat. 1657); sec. 3(f)(1), Life Insurance Company Income Tax Act 1959 (73 Stat. 140); sec. 2(c), Act of Sept. 23, 1959 (Pub. Law 86–376, 73 Stat. 699)]

§ 1.1504–1 Definitions.

The privilege of filing consolidated returns is extended to all includible corporations constituting affiliated groups as defined in section 1504. See the regulations under § 1.1502 for a description of an affiliated group and the corporations which may be considered as includible corporations.

§ 1.1505 Statutory provisions; cross references.

SEC. 1505. *Cross references.* (1) For suspension of running of statute of limitations when notice in respect of a deficiency is mailed to one corporation, see section 6503 (a) (1).

(2) For allocation of income and deductions of related trades or businesses, see section 482.

RELATED RULES

§ 1.1551 Statutory provision; disallowance of surtax exemption and accumulated earnings credit.

SEC. 1551. *Disallowance of surtax exemption and accumulated earnings credit.* If any corporation transfers, on or after January 1, 1951, all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year (except as may be otherwise determined under section 269(b)) be allowed either the $25,000 exemption from surtax provided in section 11(c) or the $100,000 accumulated earnings credit provided in paragraph (2) or (3) of section 535(c), unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. For purposes of this section, control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of the corporation. In determining the ownership of stock for the purpose of this section, the ownership of stock shall be determined in accordance with the provisions of section 544, except that constructive ownership under section 544(a)(2) shall be determined only with respect to the individual's spouse and minor children. The provisions of section 269(b), and the authority of the Secretary under such section, shall, to the extent not inconsistent with the provisions of this section, be applicable to this section.

[Sec. 1551 as amended by sec. 205(a), Small Business Tax Revision Act 1958 (72 Stat. 1680)]

§ 1.1551–1 Disallowance of surtax exemption and accumulated earnings credit.

(a) *In general.* If one corporation transfers on or after January 1, 1951, all or part of its property (other than money) to another corporation, neither the $25,000 exemption from surtax provided in section 11(c) nor the $100,000 ($60,000 if the taxable year begins before January 1, 1958) accumulated earnings credit provided in paragraph (2) or (3) of section 535(c) shall be allowed the transferee if:

(1) The transferee was created for the purpose of acquiring such property, or

(2) The transferee was not actively engaged in business at the time of the acquisition, and

(3) After such transfer, the transferor or its stockholders, or both, are in control of the transferee during any part of the taxable year of the transferee, unless,

(4) The transferee establishes by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not a major purpose of such transfer, or

(5) The Commissioner allows such exemption or credit pursuant to the authority provided in section 1551 and section 269 (b).

(b) *Purpose of section 1551.* (1) The purpose of section 1551 is to prevent avoidance or evasion of the surtax imposed by section 11 (c) or of the accumulated earnings tax imposed by section 531. It is not intended, however, that section 1551 be interpreted as delimiting or abrogating any principle of law established by judicial decision, or any existing provisions of the Code, such as sections 269 and 482, which have the effect of preventing the avoidance or evasion of income taxes. Such principles of law and such provisions of the Code, including section 1551, are not mutually exclusive, and in appropriate cases they may operate together or they may operate separately.

(2) The provisions of section 269 (b) and the authority of the Commissioner thereunder, to the extent not inconsistent with the provisions of section 1551 are applicable to cases covered by section 1551. Pursuant to the authority provided in section 269 (b) the Commissioner may allow to the transferee any part of a surtax exemption or accumulated earnings credit for a taxable year for which such exemption or credit would otherwise be disallowed under section 1551; or he may apportion such exemption or credit among the corporations involved. For example, Corporation A transfers on January 1, 1955, all its property to Corporations B and C in exchange for all the stock of such corporations. Immediately thereafter, Corporation A is dissolved and its stockholders become the sole stockholders of Corporations B and C. Assuming that Corporations B and C are unable to establish by the clear preponderance of the evidence that the securing of the surtax exemption provided in section 11 (c) or the accumulated earnings credit provided in section 535 or both, was not a major purpose of the transfer, the Commissioner, nevertheless, has authority under sections 1551 and 269 (b) to allow one such exemption and credit and to apportion such exemption and credit between Corporations B and C.

(3) For the purpose of section 1551 and this section, a corporation maintaining an office for the purpose of preserving its corporate existence is not considered to be "actively engaged in business" even though such corporation may be deemed to be "doing business" for other purposes. Similarly, for the purpose of section 1551 and this section, a corporation engaged in winding up its affairs, prior to an acquisition to which section 1551 is applicable, is not considered to be "actively engaged in business."

(c) *Meaning and application of the term "control."* (1) For the purpose of section 1551 and this section, the term "control" means the ownership of stock possessing either (i) at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or (ii) at least 80 percent of the total value of shares of all classes of stock of the corporation. In determining whether stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote is owned, all classes of such stock shall be considered together; it is not necessary that 80 percent of each class of voting stock be owned. Likewise, in determining whether stock possessing at least 80 percent of the total value of shares of all classes of stock is owned, all classes of stock of the corporation shall be considered together; it is not necessary that 80 percent of the value of shares of each class be owned. The fair market value of a share shall be considered as the value to be used for the purpose of this computation. The ownership of stock shall be determined in accordance with the provisions of section 544 and the regulations thereunder, except that constructive ownership under section 544 (a) (2) shall be determined only with respect to the individual's spouse and minor children. For example, in addition to stock held directly or under an option to purchase, an individual is deemed to own stock held directly or indirectly by or for his spouse or minor children, and also to own a proportionate part of the stock owned by a corporation, partnership, estate, or trust in which he holds an interest as a shareholder, partner, or beneficiary.

(2) Disallowance of the exemption and credit under section 1551 is not limited to the taxable year of the transferee corporation in which the transfer of property occurs. Section 1551 provides for the disallowance of the exemption and credit for any taxable year whether the taxable year in which the transfer of property occurs or any subsequent taxable year of the transferee corporation, if, during any part of such year, the transferor corporation or its stockholders, or both, are in control of the transferee corporation. Thus, if Corporation D on January 1, 1955, transfers a part of its property to Corporation E, a corporation not actively engaged in business at the time of the acquisition of such property, in exchange for 60 percent of the voting stock of Corporation E, and, thereafter, during a later taxable year with respect to which section 1551 is applicable, acquires an additional 20 percent of the voting stock of Corporation E, Corporation D, by reason of such later acquisition, is considered to be in control of Corporation E as of the time of such acquisition for the purpose of section 1551. Accordingly, Corporation E will be disallowed the surtax exemption and accumulated earnings credit for the taxable year in which the later acquisition of stock occurred and for each taxable year thereafter in which the requisite control continues, unless Corporation E establishes by the clear preponderance of the evidence that the securing of such exemption or credit, or both, was not a major purpose of the transfer of the property in 1955.

(3) In determining, for the purpose of section 1551 whether a corporation, its stockholders, or both, are in control of a transferee corporation, it is not necessary that the stock be acquired on or after January 1, 1951. Thus, if Corporation F on June 1, 1950, owns 70 percent of the voting stock of Corporation G, and, thereafter, on January 2, 1955, Corporation F acquires an additional 10 percent of such stock, control within the meaning of section 1551 is acquired by Corporation F on January 2, 1955.

(d) *Nature of transfer.* A transfer made by any corporation of all or part of its assets, whether or not such transfer qualifies as a reorganization under section 368 is within the scope of section 1551 except that section 1551 does not apply to a transfer of money only. For example, the transfer of cash for the purpose of expanding the business of the transferor corporation through the formation of a new corporation is not a transfer within the scope of section 1551 irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property.

(e) *Purpose of transfer.* In determining, for the purpose of section 1551, whether the securing of the exemption from surtax or the accumulated earnings credit constituted "a major purpose" of the transfer, all circumstances relevant to the transfer shall be considered. For disallowance of the surtax exemption and accumulated earnings credit under section 1551, it is not necessary that the obtaining of either such credit or exemption or both have been the sole or principal purpose of the transfer of the property. It is sufficient if it appears, in the light of all the facts and circumstances, that the obtaining of such exemption or credit, or both, was one of the major considerations that prompted the transfer. Thus, the securing of the surtax exemption or the accumulated earnings credit may constitute "a major purpose" of the transfer, notwithstanding that such transfer was effected for a valid business purpose and qualified as a reorganization within the meaning of section 368. The taxpayer's burden of establishing by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not "a major purpose" of the transfer may be met, for example, by a showing that the obtaining of such exemption, or credit, or both, was not a major factor in relationship to the other consideration or considerations which prompted the transfer.

§ 1.1552 Statutory provisions; earnings and profits.

SEC. 1552. *Earnings and profits.*—(a) *General rule.*—Pursuant to regulations prescribed by the Secretary or his delegate the earnings and profits of each member of an affiliated group required to be included in a consolidated return for such group filed for a taxable year beginning after December 31, 1953, and ending after the date of enactment of this title, shall be determined by allocating the tax liability of the group for such year among the members of the group in accord with whichever of the following methods the group shall elect in its first consolidated return filed for such a taxable year:

(1) The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income.

(2) The tax liability of the group shall be allocated to the several members of the group on the basis of the percentage of the total tax which the tax of such member if computed on a separate return would bear to the total amount of the taxes for all members of the group so computed.

(3) The tax liability of the group (excluding the tax increases arising from the consolidation) shall be allocated on the basis of the contribution of each member of the group to the consolidated taxable income of the group. Any tax increases arising from the consolidation shall be distributed to the several members in direct proportion to the reduction in tax liability resulting to such members from the filing of the consolidated return as measured by the difference between their tax liabilities determined on a separate return basis and their tax liabilities (determined without regard to the 2 percent increase provided by section 1503 (a)) based on their contributions to the consolidated taxable income.

(4) The tax liability of the group shall be allocated in accord with any other method selected by the group with the approval of the Secretary or his delegate.

(b) *Failure to elect.* If no election is made in such first return, the tax liability shall be allocated among the several members of the group pursuant to the method prescribed in subsection (a) (1).

§ 1.1552–1 Earnings and profits.

(a) *General rule.* For the purpose of determining the earnings and profits of each member of an affiliated group which is required to be included in a consolidated return for such group filed for a taxable year beginning after December 31, 1953, and ending after August 16, 1954, the tax liability of the group shall be allocated among the members of the group in accordance with whichever of the following methods the group shall elect in its first consolidated return for such a taxable year:

(1) The tax liability shall be apportioned among the members of the group in accordance with the ratio which that portion of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income.

(2) The tax liability of the group shall be allocated to the several members of the group on the basis of the percentage of the total tax which the tax of such member if computed on a separate return would bear to the total amount of the taxes for all members of the group so computed.

(3) The tax liability of the group (excluding the tax increases arising from the consolidation) shall be allocated on the basis of the contribution of each member of the group to the consolidated taxable income of the group. Any tax increases arising from the consolidation shall be distributed to the several members in direct proportion to the reduction in tax liability resulting to such members from the filing of the consoli-

dated return as measured by the difference between their tax liabilities determined on a separate return basis and their tax liabilities (determined without regard to the 2-percent increase provided by section 1503(a) and paragraph (a) of § 1.1502–30) based on their contributions to the consolidated taxable income.

(4) The tax liability of the group shall be allocated in accord with any other method selected by the group with the approval of the Commissioner.

(b) *Method of election.* The election under section 1552 (a) (1), (2), or (3) shall be made not later than the time prescribed by law for filing the first consolidated return of the group for a taxable year beginning after December 31, 1953, and ending after August 16, 1954 (including extensions thereof). If the group elects to allocate its tax liability in accordance with the method prescribed in section 1552 (a) (1), (2), or (3), a statement shall be attached to the return so stating. Such statement shall be made by the common parent corporation and shall be binding upon all members of the group. In the event that the group desires to allocate its tax liability in accordance with any other method pursuant to section 1552 (a) (4), approval of such method by the Commissioner must be obtained within the time prescribed above. If such approval is not obtained in such time, the group shall allocate in accordance with the method prescribed in section 1552 (a) (1). The request shall state fully the method which the group wishes to apply in apportioning the tax liability. An election once made shall be irrevocable and shall be binding upon the group with respect to the year for which made and for all future years for which a consolidated return is filed or required to be filed unless the Commissioner authorizes a change to another method prior to the time prescribed by law for filing the return for the year in which such change is to be effective.

(c) *Failure to elect.* If a group fails to make an election in accordance with paragraph (b) of this section, the method prescribed under section 1552 (a) (1) shall be applicable and shall be binding upon the group in the same manner as if an election had been made to so allocate.

Procedure and Administration

INFORMATION AND RETURNS

RETURNS AND RECORDS

RECORDS, STATEMENTS, AND SPECIAL RETURNS

§ 1.6001 Statutory provisions; notice or regulations requiring records, statements, and special returns.

SEC. 6001. *Notice or regulations requiring records, statements, and special returns.* Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title.

§ 1.6001–1 Records.

(a) *In general.* Except as provided in paragraph (b) of this section, any person subject to tax under subtitle A of the Code, or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.

(b) *Farmers and wage-earners.* Individuals deriving gross income from the business of farming, and individuals whose gross income includes salaries, wages, or similar compensation for personal services rendered, are required with respect to such income to keep such records as will enable the district director to determine the correct amount of income subject to the tax. It is not necessary, however, that with respect to such income individuals keep the books of account or records required by paragraph (a) of this section. For rules with respect to the records to be kept in substantiation of traveling and other business expenses of employees, see § 1.162–17.

(c) *Exempt organizations.* In addition to such permanent books and records as are required by paragraph (a) of this section with respect to the tax imposed by section 511 on unrelated business income of certain exempt organizations, every organization exempt from tax under section 501(a) but required by section 6033 to file an annual return shall keep such permanent books of account or records, including inventories, as are sufficient to show specifically the items of gross income, receipts, and disbursements, and such other information as is required by section 6033. See section 6033 and § 1.6033–1.

(d) *Notice by district director requiring returns, statements, or the keeping of records.* The district director may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not such person is liable for tax under subtitle A of the Code.

(e) *Retention of records.* The books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

TAX RETURNS OR STATEMENTS

§ 1.6011 Statutory provisions; general requirement of return, statement, or list.

SEC. 6011. *General requirement of return, statement, or list*—(a) *General rule.* When required by regulations prescribed by the Secretary or his delegate any person made liable for any tax imposed by this title, or for the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary or his delegate. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

* * * * *

(d) *Income, estate, and gift taxes.* For requirement that returns of income, estate, and gift taxes be made whether or not there is tax liability, see sections 6012 to 6019, inclusive.

[Sec. 6011 as amended by sec. 161, Excise Tax Technical Changes Act 1958 (72 Stat. 1305)]

§ 1.6011–1 General requirement of return, statement, or list.

(a) *General rule.* Every person subject to any tax, or required to collect any tax, under subtitle A of the Code, shall make such returns or statements as are required by the regulations in this chapter. The return or statement shall include therein the information required by the applicable regulations or forms.

(b) *Use of prescribed forms.* Copies of the prescribed return forms will so far as possible be furnished taxpayers by district directors. A taxpayer will not be excused from making a return, however, by the fact that no return form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the district director in ample time to have their returns prepared, verified, and filed on or before the due date with the internal revenue office where such returns are required to be filed. Each taxpayer should carefully prepare his return and set forth fully and clearly the information required to be included therein. Returns which have not been so prepared will not be accepted as meeting the requirements of the Code. In the absence of a prescribed form, a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and, if filed within the prescribed time, the statement so made will relieve the taxpayer from liability for the addition to tax imposed for the delinquent filing of the return, provided that without unnecessary delay such a tentative return is supplemented by a return made on the proper form.

§ 1.6012 Statutory provisions; persons required to make returns of income.

SEC. 6012. *Persons required to make returns of income*—(a) *General rule.* Returns with respect to income taxes under subtitle A shall be made by the following:

(1) Every individual having for the taxable year a gross income of $600 or more (except that any individual who has attained the age of 65 before the close of his taxable year shall be required to make a return only if he has for the taxable year a gross income of $1,200 or more);

(2) Every corporation subject to taxation under subtitle A;

(3) Every estate the gross income of which for the taxable year is $600 or more;

(4) Every trust having for the taxable year any taxable income, or having gross income of $600 or over, regardless of the amount of taxable income; and

(5) Every estate or trust of which any beneficiary is a nonresident alien;

except that subject to such conditions, limitations, and exceptions and under such regulations as may be prescribed by the Secretary or his delegate, nonresident alien indi-

viduals subject to the tax imposed by section 871 and foreign corporations subject to the tax imposed by section 881 may be exempted from the requirement of making returns under this section.

(b) *Returns made by fiduciaries and receivers*—(1) *Returns of decedents.* If an individual is deceased, the return of such individual required under subsection (a) shall be made by his executor, administrator, or other person charged with the property of such decedent.

(2) *Persons under a disability.* If an individual is unable to make a return required under subsection (a) or section 6015 (a), the return of such individual shall be made by a duly authorized agent, his committee, guardian, fiduciary or other person charged with the care of the person or property of such individual. The preceding sentence shall not apply in the case of a receiver appointed by authority of law in possession of only a part of the property of an individual.

(3) *Receivers, trustees and assignees for corporations.* In a case where a receiver, trustee in bankruptcy, or assignee, by order of a court of competent jurisdiction, by operation of law or otherwise, has possesssion of or holds title to all or substantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns.

(4) *Returns of estates and trusts.* Returns of an estate or a trust shall be made by the fiduciary thereof.

(5) *Joint fiduciaries.* Under such regulations as the Secretary or his delegate may prescribe, a return made by one of two or more joint fiduciaries shall be sufficient compliance with the requirements of this section. A return made pursuant to this paragraph shall contain a statement that the fiduciary has sufficient knowledge of the affairs of the person for whom the return is made to enable him to make the return, and that the return is, to the best of his knowledge and belief, true and correct.

(c) *Certain income earned abroad.* For purposes of this section, gross income shall be computed without regard to the exclusion provided for in section 911 (relating to earned income from sources without the United States).

(d) *Consolidated returns.* For provisions relating to consolidated returns by affiliated corporations, see chapter 6.

[Sec. 6012 as amended by sec. 72(a), Technical Amendments Act 1958 (72 Stat. 1660)]

§ 1.6012–1 Individuals required to make returns of income.

(a) *Individual citizen or resident*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, an income tax return must be filed for each taxable year by every individual who receives $600 or more of gross income during such taxable year and who is—

(i) A citizen of the United States, whether residing at home or abroad,

(ii) A resident of the United States even though not a citizen thereof, or

(iii) An alien bona fide resident of Puerto Rico during the entire taxable year.

Such return must be filed by such individual regardless of his family or marital status.

(2) *Certain exceptions.* (i) In case an individual who is described in subparagraph (1) of this paragraph has attained the age of 65 before the close of his taxable year, an income tax return must be filed by such individual only if he receives $1,200 or more of gross income during his taxable year.

(ii) In the case of a short taxable year referred to in section 443(a)(1), an individual described in subparagraph (1) of this paragraph shall file an income tax return if his gross income received during such short taxable year equals or exceeds his own personal exemption allowed by section 151(b) (prorated as provided in section 443(c)) and, when applicable, his additional exemption for age 65 or more allowed by section 151(c)(1) (prorated as provided in section 443(c)).

(3) *Earned income from without the United States.* For the purpose of determining whether an income tax return must be filed for any taxable year beginning after December 31, 1957, gross income shall be computed without regard to the exclusion provided for in section 911 (relating to earned income from sources without the United States). In the case of an individual claiming an exclusion under such section, he shall attach Form 2555 to the return required under this paragraph.

(4) *Return of income of minor.* A minor is subject to the same requirements and elections for making returns of income as are other individuals. Thus, a return of income must be made by or for a minor who has a total of $600 of gross income, regardless of the amount of his taxable income. For example, a return must be made by or for a minor who has an aggregate of $600 gross income from funds held in trust for him and from his personal services. The return of a minor must be made by the minor himself or must be made for him by his guardian or other person charged with the care of the minor's person or property. See paragraph (b)(3) of § 1.6012–3. See § 1.73–1 for inclusion in the minor's gross income of amounts received for his personal services. For the amount of tax which is considered to have been properly assessed against the parent, if not paid by the child, see section 6201(c) and paragraph (c) of § 301.6201–1 of this chapter (Regulations on Procedure and Administration).

(5) *Returns made by agents.* The return of income may be made by an agent if the person liable for the making of the return is unable to make it by reason of illness or continuous absence from the United States for a period of at least 60 days before the date prescribed by law for making the return. However, assistance in the preparation of the return may be rendered under any circumstances. Whenever a return is made by an agent it shall be accompanied by the prescribed power of attorney, Form 935, except that an agent holding a valid and subsisting general power of attorney authorizing him to represent his principal in making, executing, and filing the income return, may submit a certified copy thereof in lieu of the authorization on Form 935. The agent, as well as the taxpayer, may incur liability for the penalties provided for erroneous, false, or fraudulent returns. For a return of an agent for a nonresident alien individual, see paragraph (b)(6) of this section. For the requirements regarding signing of returns, see § 1.6061–1.

(6) *Form of return.* Form 1040 is prescribed for general use in making the return required under this paragraph. Form 1040A and Form 1040W are optional short forms which, in accordance with subparagraphs (7) and (8), respectively, of this paragraph, may be used by certain taxpayers. A taxpayer entitled to use Form 1040W in making his return for a taxable year may nevertheless use Form 1040 as his return for such year. A taxpayer otherwise entitled to use Form 1040A as his return for any taxable year may not make his return on such form if he elects not to take the standard deduction provided in section 141, and in such case he must make his return on Form 1040 or Form 1040W. However, a taxpayer entitled under section 6014 and § 1.6014–1 to elect not to show the tax on his return must, if he desires to exercise such election, make his return on Form 1040A.

(7) *Use of Form 1040A by certain taxpayers with gross income less than $10,000*—(i) *In general.* Subject to the limitations set forth in subdivisions (ii), (iii), (iv), and (v) of this subparagraph, and in accordance with Form 1040A and the instructions provided with respect to such form, an individual may use Form 1040A as his return for any taxable year in which the gross income of the individual—

(*a*) Is less than $10,000,

(*b*) Consists entirely of remuneration for personal services performed as an employee, dividends, or interest, and

(*c*) Does not include more than $200 from dividends, interest, and remuneration for personal services other than wages, as defined in section 3401(a).

For purposes of determining whether gross income from dividends, interest, and remuneration other than wages, as defined in section 3401(a), exceeds $200, dividends from domestic corporations are taken into account to the extent that they are includible in gross income.

(ii) *Restrictions on use of Form 1040A.* Form 1040A shall not be used by an individual—

(*a*) Who elects to itemize his deductions;

(*b*) Whose spouse makes a separate return on Form 1040 or Form 1040W and elects to itemize deductions;

(*c*) Who is a nonresident alien individual;

(*d*) Who is a citizen of the United States entitled to the benefits of section 931 (relating to income from sources within possessions of the United States);

(*e*) Who makes a return under section 443(a)(1) for a period of less than 12 months on account of a change in his accounting period;

(*f*) Who makes a return on a fiscal year basis;

(*g*) Who makes a return by use of a method of accounting other than the cash receipts and disbursements method;

(*h*) Who claims that amounts included in the statement of wages under section 6051 are excluded under section 105 (d);

(i) Who claims any of the deductions referred to in section 62, for example, the deductions for travel or transportation expense;

(j) Who claims a deduction for an exemption upon a multiple support agreement under section 152(c); or

(k) Who claims credit for payment of estimated income tax or for an overpayment of income tax for the previous taxable year.

(iii) *Credits not allowable.* When Form 1040A is used, the following credits shall not be allowed:

(a) The credit provided by section 32 for tax withheld at source under subchapter B, chapter 3 of the Code;

(b) The credit provided by section 33 for taxes imposed by foreign countries and possessions of the United States;

(c) The credit provided by section 34 for dividends received;

(d) The credit provided by section 35 for partially tax-exempt interest; and

(e) The credit provided by section 37 for retirement income.

(iv) *Status benefits not allowable.* The status of a taxpayer as head of household as defined in section 1(b)(2), or as a surviving spouse, as defined in section 2(b), shall not be considered in determining the tax liability of a taxpayer filing Form 1040A.

(v) *Use after due date not permitted.* Form 1040A shall not be used unless it is filed on or before the date prescribed in section 6072(a) for the filing of the return.

(vi) *Computation and payment of tax.* Unless a taxpayer is entitled to elect under section 6014 and § 1.6014–1 not to show the tax on Form 1040A and does so elect, he shall compute and show on his return on Form 1040A the amount of the tax imposed by subtitle A of the Code and shall, without notice and demand therefor, pay any unpaid balance of such tax not later than the date fixed for filing the return.

(8) *Use of Form 1040W by certain taxpayers irrespective of amount of gross income.* In accordance with Form 1040W and the instructions provided with respect to such form, an individual may use Form 1040W as his return for any taxable year beginning after December 31, 1958, in which the gross income of the individual, regardless of the amount thereof—

(i) Consists entirely of remuneration for personal services performed as an employee (whether or not such remuneration constitutes wages as defined in section 3401(a)), dividends, or interest, and

(ii) Does not include more than $200 from dividends and interest.

For purposes of determining whether gross income from dividends and interest exceeds $200, dividends from domestic corporations are taken into account to the extent that they are includible in gross income.

(9) *Change of election to use Form 1040A or Form 1040W.* A taxpayer who has elected to make his return on Form 1040A or Form 1040W may change such election. Such change of election shall be within the time and subject to the conditions prescribed in section 144(b) and § 1.144–2, relating to change of election to take, or not to take, the standard deduction.

(10) *Joint return of husband and wife on Form 1040A or Form 1040W.* A husband and wife, eligible under section 6013 and the regulations thereunder to file a joint return for the taxable year, may, subject to the provisions of subparagraphs (7) and (8) of this paragraph, make a joint return—

(i) On Form 1040A for any such year in which the aggregate gross income of the spouses is less than $10,000, consists entirely of remuneration for services performed as an employee, dividends, or interest, and does not include more than $200 from dividends, interest, and remuneration other than wages as defined in section 3401(a); or

(ii) On Form 1040W for any such taxable year beginning after December 31, 1958, in which the aggregate gross income of the spouses (regardless of amount) consists entirely of remuneration for personal services performed as an employee (whether or not such remuneration constitutes wages as defined in section 3401(a)), dividends, or interest, and does not include more than $200 from dividends and interest.

For purposes of determining whether gross income from sources to which the $200 limitation applies exceeds such amount in cases where both spouses receive dividends from domestic corporations, the amount of such dividends received by each spouse is taken into account to the extent that such dividends are includible in gross income. See section 116 and §§ 1.116–1 and 1.116–2. If a joint return is made by husband and wife on Form 1040A or Form 1040W, the liability for the tax shall be joint and several.

(b) *Returns of nonresident alien individuals*—(1) *Individuals in class 1 (no United States business and gross income of not more than $15,400)*—(i) *Return not required.* If the tax liability of a nonresident alien individual within class 1, as described in paragraph (a)(1) of § 1.871–7, is fully satisfied at the source, a return of income is not required.

(ii) *Return required.* A nonresident alien individual within class 1 shall make or have made a return on Form 1040NB with respect to that portion of his income described in paragraph (b) of § 1.871–7 upon which the tax has not been fully satisfied at the source, including such income upon which the tax is limited by tax convention. A return shall be made in such instance even though the individual's gross income from sources within the United States for the taxable year is less than $600.

(iii) *Items upon which tax not fully satisfied.* Some of the items of income from sources within the United States upon which the tax liability will not have been fully satisfied at the source are—

(a) Interest upon so-called tax-free covenant bonds upon which, in accordance with § 1.1451–1, a tax of only 2 percent is required to be withheld at the source;

(b) Capital gains described in paragraph (b)(4) of § 1.871–7, which are not subject to withholding under § 1.1441–1;

(c) Accrued interest received in connection with the sale of bonds between interest dates, which, in accordance with paragraph (a)(2) of § 1.1441–4, is not subject to withholding; and

(d) Dividends from foreign corporations which are not subject to withholding under paragraph (b)(2) of § 1.1441–3 but do constitute income from sources within the United States under paragraph (a)(2) of § 1.861–3.

(iv) *Claim for refund.* Notwithstanding the provisions of subdivisions (i) and (ii) of this subparagraph, a nonresident alien individual within class 1 shall include on Form 1040NB his entire income described in paragraph (b) of § 1.871–7, whether or not the tax has been fully satisfied at the source upon a portion thereof, if a claim for the refund of an overpayment of tax is made in accordance with section 6402 and the regulations thereunder. However, if the overpayment to be refunded consists solely of tax deemed to have been paid under section 852(b)(3)(D), relating to undistributed capital gains of a regulated investment company, it is not necessary to include on the Form 1040NB the entire income described in paragraph (b) of § 1.871–7.

(2) *Individuals in class 2 (no United States business and gross income of more than $15,400).* Even though the tax has been fully satisfied at the source, every nonresident alien individual within class 2, as described in paragraph (a)(2) of § 1.871–7, shall make or have made a return on Form 1040NB–a of all his income described in paragraph (c) of § 1.871–7, including such income upon which the tax is limited by tax convention. However, if the gross income of an individual within class 2 consists of treaty income only, as defined in paragraph (e) of § 1.871–7, or if the nontreaty income does not exceed $15,400 in the aggregate, the return shall be made on Form 1040NB in the manner and to the extent otherwise required in subparagraph (1) of this paragraph. See paragraph (e)(2) of § 1.871–7.

(3) *Individuals in class 3 (United States business).* Every nonresident alien individual within class 3, as described in paragraph (a)(3) of § 1.871–7, shall make or have made a return on Form 1040B of all his income described in paragraph (d) of § 1.871–7, including such income upon which the tax is limited by tax convention, even though his gross income from sources within the United States for the taxable year is less than $600. No exception is made to this requirement in the case of such an individual who is a resident of Canada or Mexico. However, if the gross income of a nonresident alien individual within class 3 consists of treaty income only and the tax is determined by applying the limited rates applicable under the convention, then the return shall be made on Form 1040NB in the manner and to the extent otherwise required by subparagraph (1) of this paragraph. See para-

graph (e) (3) and (5) of § 1.871–7. When used for this purpose, Form 1040NB shall be appropriately marked in accordance with the instructions issued with respect to the return.

(4) *Treaty income.* If the gross income of a nonresident alien individual to which this paragraph applies includes income on which the tax is limited by tax convention, see paragraph (e) of § 1.871–7.

(5) *Claims for refund*—(i) *Forms to use.* In the case of any overpayment of income tax by a nonresident alien individual to which this paragraph applies, claim for refund may be made in accordance with section 6402 and the regulations thereunder.

(ii) *Tax withheld at source.* If an overpayment has resulted from the withholding of tax at source under chapter 3 of the Code, statements shall be attached to the claim for refund showing accurately (*a*) the amounts of tax withheld, with the names and post office addresses of withholding agents and, (*b*) if applicable, facts sufficient to show that, at the time when the income was derived, the taxpayer was entitled to the benefit of a reduced rate of, or exemption from, tax with respect to that income under the provisions of a tax convention to which the United States is a party. For an illustration of the statements to be furnished when claiming the benefit of a reduced rate or exemption under a tax convention, see 26 CFR (1939) 7.710 (Treasury Decision 6030, approved July 10, 1953); § 501.11 of this chapter (Treasury Decision 6108, approved October 13, 1954); and § 502.10 of this chapter (Treasury Decision 6109, approved October 13, 1954). For the refund to the withholding agent of an overpayment of the tax under chapter 3 of the Code, see § 1.1464–1.

(6) *Representative or agent for nonresident alien individuals*—(i) *In general.* The responsible representative or agent within the United States of a nonresident alien individual shall make in behalf of his nonresident alien principal a return of, and shall pay the tax on, all income from sources within the United States coming within his control as representative or agent. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes. Any person who collects interest or dividends on deposited securities of a nonresident alien individual, executes ownership certificates in connection therewith, or sells such securities under special instructions shall not be deemed merely by reason of such acts to be the responsible representative or agent of the nonresident alien individual.

(ii) *Income to be returned.* A return of income shall be required under this subparagraph only if the nonresident alien individual is otherwise required to make a return in accordance with this paragraph. The provisions of this paragraph shall apply in determining the form of return to be used and the income to be returned.

(c) *Cross reference.* For returns by fiduciaries for individuals, estates, and trusts, see § 1.6012–3.

§ 1.6012–2 Corporations required to make returns of income.

(a) *In general*—(1) *Requirement of return.* Except as provided in paragraphs (e) and (g) (1) of this section with respect to charitable and other organizations having unrelated business income and to certain foreign corporations, respectively, every corporation, as defined in section 7701(a) (3), subject to taxation under subtitle A of the Code shall make a return of income regardless of whether it has taxable income or regardless of the amount of its gross income.

(2) *Existence of corporation.* A corporation in existence during any portion of a taxable year is required to make a return. If a corporation was not in existence throughout an annual accounting period (either calendar year or fiscal year), the corporation is required to make a return for that fractional part of a year during which it was in existence. A corporation is not in existence after it ceases business and dissolves, retaining no assets, whether or not under State law it may thereafter be treated as continuing as a corporation for certain limited purposes connected with winding up its affairs, such as for the purpose of suing and being sued. If the corporation has valuable claims for which it will bring suit during this period, it has retained assets and therefore continues in existence. A corporation does not go out of existence if it is turned over to receivers or trustees who continue to operate it. If a corporation has received a charter but has never perfected its organization and has transacted no business and has no income from any source, it may upon presentation of the facts to the district director be relieved from the necessity of making a return. In the absence of a proper showing of such facts to the district director, a corporation will be required to make a return.

(3) *Form of return.* The return required of a corporation under this section shall be made on Form 1120 unless the corporation is of a type for which a special form is prescribed. The special forms of returns and schedules required of particular types of corporations are set forth in paragraphs (b) to (g), inclusive, of this section.

(b) *Personal holding companies.* A personal holding company, as defined in section 542, including a foreign corporation within the definition of such section, shall attach Schedule PH, Computation of U.S. Personal Holding Company Tax, to the return required by paragraph (a) or (g), as the case may be, of this section.

(c) *Insurance companies*—(1) *Life insurance companies.* A life insurance company subject to tax under section 802 or 811 shall make a return on Form 1120L. There shall be filed with the return (i) a copy of the annual statement, the form of which has been approved by the National Association of Insurance Commissioners, which is filed by the company for the year covered by such return with the insurance departments of States, Territories, and the District of Columbia, and which shows the reserves used by the company in computing the taxable income reported on its return, and (ii) copies of Schedule A (real estate) and Schedule D (bonds and stocks) of such annual statement.

(2) *Mutual insurance companies.* A mutual insurance company (other than a life or marine insurance company and other than a fire insurance company subject to the tax imposed by section 831) or an interinsurer or reciprocal underwriter subject to tax under section 821 shall make a return on Form 1120M. See paragraph (a) (3) of § 1.821–1. There shall be filed with the return (i) a copy of the annual statement, the form of which has been approved by the National Association of Insurance Commissioners, which is filed by the company for the year covered by such return with the insurance departments of States, Territories, and the District of Columbia, and (ii) copies of Schedule A (real estate) and Schedule D (bonds and stocks) of such annual statement.

(3) *Other insurance companies.* Every insurance company (other than a life or mutual insurance company), every mutual marine insurance company, and every mutual fire insurance company, subject to tax under section 831, and every mutual savings bank conducting a life insurance business and subject to tax under section 594, shall make a return on Form 1120. See paragraph (c) of § 1.831–1. There shall be filed with the return a copy of the annual statement, the form of which has been approved by the National Association of Insurance Commissioners, which contains the underwriting and investment exhibit for the year covered by such return.

(4) *Foreign insurance companies.* The provisions of subparagraphs (1), (2), and (3) of this paragraph concerning the returns and statements of insurance companies subject to tax under section 802 or 811, section 821, and section 831, respectively, are applicable to foreign insurance companies subject to tax under such sections, except that the copy of the annual statement, the form of which has been approved by the National Association of Insurance Commissioners, required to be submitted with the return shall, in the case of a foreign insurance company, be a copy of the statement relating to the United States business of such company.

(d) *Affiliated groups.* For the forms to be used by affiliated corporations filing a consolidated return, see § 1.1502–12.

(e) *Charitable and other organizations with unrelated business income.* Every organization, described in section 501 (c) (2), (3), (5), and (6), which is otherwise exempt from tax under section 501 (a), and which is subject to the tax imposed on unrelated business taxable income by section 511 (a) (1), shall make a return on Form 990–T for each taxable year if it has gross income, included in computing unrelated business taxable income for such taxable year, of $1,000 or more. A return on Form 990–T shall also be made for each taxable year by

every governmental college or university and by every corporation wholly owned by such a college or university, which is subject to the tax on unrelated business taxable income and which has gross income, included in computing unrelated business taxable income for such taxable year, of $1,000 or more. The filing of a return of unrelated business income does not relieve the organization of the duty of filing other required returns.

(f) *Farmers' cooperatives.* Farmers' cooperative organizations described in section 521 are required to make a return of income whether or not such organizations are, under section 522, subject to the taxes imposed by section 11 or section 1201. The return shall be made on Form 990-C.

(g) *Returns by foreign corporations*—(1) *Nonresident foreign corporations*—(i) *In general.* A nonresident foreign corporation is not required to make a return of income if the tax liability of the corporation is fully satisfied at the source. A nonresident foreign corporation shall, however, make or have made a return on Form 1120NB with respect to that portion of its income described in § 1.881–2 upon which the tax has not been fully satisfied at the source, including such income upon which the tax is limited by tax convention. The tax liability of a nonresident foreign corporation is not fully satisfied at the source in any case where, if it were not for the allowance of deductions to such corporation, it would be liable for tax. For example, the tax liability of a nonresident foreign corporation which is a personal holding company (as defined in section 542) is not fully satisfied at the source if such corporation would be liable for the personal holding company tax imposed by section 541 if it were not for the fact that it may be allowed a deduction for dividends paid (as defined in section 561). See section 545, relating to the definition of undistributed personal holding company income, and section 882 (c)(1), relating to allowance of deductions only if a return is filed.

(ii) *Claim for refund.* Notwithstanding the provisions of subdivision (i) of this subparagraph, a nonresident foreign corporation shall include on Form 1120NB its entire income described in § 1.881–2, whether or not the tax has been fully satisfied at the source upon a portion thereof, if a claim for refund of an overpayment of tax is made in accordance with section 6402 and the regulations thereunder. However, if the overpayment to be refunded consists solely of tax deemed to have been paid under section 852(b)(3)(D), relating to undistributed capital gains of a regulated investment company, it is not necessary to include on the Form 1120NB the entire income described in § 1.881–2.

(2) *Resident foreign corporations.* Every resident foreign corporation shall make or have made a return on Form 1120 of all its income described in § 1.882–1, including such income upon which the tax is limited by tax convention.

(3) *Treaty income.* If the gross income of a foreign corporation includes income upon which the tax is limited by tax convention, see paragraph (f) of § 1.881–2 in the case of a nonresident foreign corporation, or paragraph (a)(7) of § 1.882–1 in the case of a resident foreign corporation.

(4) *Returns by agent.* If at the time the return is filed a foreign corporation has no office or place of business within the United States but has an agent in the United States, the return required by this paragraph shall be made by the agent. See section 882(d).

(5) *Claims for refund*—(i) *Form to use.* In the case of any overpayment of income tax by a foreign corporation to which this paragraph applies, claim for refund shall be made in accordance with section 6402 and the regulations thereunder.

(ii) *Tax withheld at source.* If an overpayment has resulted from the withholding of tax at source under chapter 3 of the Code, statements shall be attached to the claim for refund showing the same information as is required by paragraph (b)(5) of § 1.6012–1 in the case of a claim for refund by a nonresident alien individual.

(6) *Special return forms.* For provisions relating to—

(i) Returns of foreign corporations which are personal holding companies as defined in section 542, see paragraph (b) of this section;

(ii) Returns of foreign insurance companies subject to tax under section 802 or 811, section 821, or section 831, see paragraph (c) of this section; and

(iii) Returns with respect to the tax imposed by section 511 upon unrelated business income described in section 512, see paragraph (e) of this section.

(h) *Other provisions.* For returns by fiduciaries for corporations, see § 1.6012–3. For information returns by corporations contemplating dissolution or liquidation and for information returns by corporations of distributions in liquidation, see §§ 1.6043–1 and 1.6043–2, respectively. For information returns by corporations relating to corporate dividends, earnings, and profits, see § 1.6042–1. For returns as to formation or reorganization of foreign corporations, see § 1.6046–1. For information returns of officers, directors, and shareholders of foreign personal holding companies, as defined in section 552, see §§ 1.6035–1 and 1.6035–2.

§ 1.6012–3 Returns by fiduciaries.

(a) *For estates and trusts*—(1) *In general.* Every fiduciary, or at least one of joint fiduciaries, must make a return of income on Form 1041—

(i) For each estate for which he acts if the gross income of such estate for the taxable year is $600 or more;

(ii) For each trust for which he acts, except a trust exempt under section 501 (a), if such trust has for the taxable year any taxable income, or has for the taxable year gross income of $600 or more regardless of the amount of taxable income; and

(iii) For each estate and each trust for which he acts, except a trust exempt under section 501 (a), regardless of the amount of income for the taxable year, if any beneficiary of such estate or trust is a nonresident alien.

(2) *Gross income of $5,000 or more.* In cases in which the gross income of the estate or trust is $5,000 or over for any taxable year, a copy of the will or trust instrument, accompanied by a written declaration of the fiduciary under the penalties of perjury that it is a true and complete copy, must be filed with the fiduciary return of the estate or trust, together with a statement by the fiduciary indicating the provisions of the will or trust instrument which, in his opinion, determine the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively. If, however, a copy of the will or trust instrument, and statement relating to the provisions of the will or trust instrument, have once been filed, they need not again be filed if the fiduciary return contains a statement showing when and where they were filed. If the trust instrument is amended in any way after such copies have been filed, a copy of the amendment must be filed by the fiduciary with the return for the taxable year in which the amendment was made. The fiduciary must also file with such amendment a statement indicating the effect, if any, in his opinion, of the amendment on the extent to which the income of the estate or trust is taxable to the estate or trust, the beneficiaries, or the grantor, respectively.

(3) *Domiciliary and ancillary representatives.* In the case of an estate required to file a return under subparagraph (1) of this paragraph, having both domiciliary and ancillary representatives, the domiciliary and ancillary representatives must each file a return on Form 1041. The domiciliary representative is required to include in the return rendered by him as such domiciliary representative the entire income of the estate. The return of the ancillary representative shall be filed with the district director for his internal revenue district and shall show the name and address of the domiciliary representative, the amount of gross income received by the ancillary representative, and the deductions to be claimed against such income, including any amount of income properly paid or credited by the ancillary representative to any legatee, heir, or other beneficiary. If the ancillary representative for the estate of a nonresident alien is a citizen or resident of the United States, and the domiciliary representative is a nonresident alien, such ancillary representative is required to render the return otherwise required of the domiciliary representative.

(4) *Two or more trusts.* A trustee of two or more trusts must make a separate return for each trust, even though such trusts were created by the same grantor for the same beneficiary or beneficiaries.

(5) *Trusts with unrelated business income.* Every fiduciary for a trust, described in section 501 (c)(3), or section 401 (a), which is otherwise exempt from tax under section 501 (a), and which is subject to the tax imposed on unrelated business taxable income by section 511

(b) (1), shall make a return on Form 990–T for each taxable year if the trust has gross income, included in computing unrelated business taxable income for such taxable year, of $1,000 or more. The filing of a return of unrelated business income does not relieve the fiduciary of such trust from the duty of filing other required returns.

(b) *For other persons*—(1) *Decedents.* The executor or administrator of the estate of a decedent, or other person charged with the property of a decedent, shall make the return of income required in respect of such decedent. For the decedent's taxable year which ends with the date of his death, the return shall cover the period during which he was alive. For the filing of returns of income for citizens and alien residents of the United States, and alien residents of Puerto Rico, see paragraph (a) of § 1.6012–1. For the filing of a joint return after death of spouse, see paragraph (d) of § 1.6013–1.

(2) *Nonresident alien individuals*—(i) *In general.* Except as otherwise provided in paragraph (b)(6) of § 1.6012–1, a resident or domestic fiduciary or other person charged with the care of the person or property of a nonresident alien individual shall make a return for that individual and pay the tax. However, if the nonresident alien individual has appointed a person in the United States to act as his agent for the purpose of making a return of income, the fiduciary or other person charged with the care of the person or property of that individual shall not be required to make a return and pay the tax in accordance with this subparagraph. In such case, if the fiduciary is required to file Form 1041 for an estate or trust of which the nonresident alien individual is a beneficiary, the fiduciary shall attach a copy of the agency appointment to his return on Form 1041.

(ii) *Income to be returned.* A return of income shall be required under this subparagraph only if the nonresident alien individual is otherwise required to make a return in accordance with paragraph (b) of § 1.6012–1. The provisions of that paragraph shall apply in determining the form of return to be used and the income to be returned.

(iii) *Allowance of deductions and credits.* The nonresident alien individual shall receive the benefit of the deductions and credits allowed to him with respect to the income tax only if, pursuant to section 874, the return so filed in accordance with this subparagraph constitutes a true and accurate return of the taxpayer's total income received from all sources within the United States and required to be returned in accordance with paragraph (b) of § 1.6012–1. However, this subdivision shall not be construed to deny the credits provided by sections 31 and 32 for tax withheld at the source.

(iv) *Alien resident of Puerto Rico.* This subparagraph shall not apply to the return of a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year. See § 1.876–1.

(v) *Cross reference.* For requirements of withholding of tax at source on nonresident aliens and of returns with respect to such withheld taxes, see §§ 1.1441–1 to 1.1441–5 and §§ 1.1461–1 to 1.1461–3, respectively.

(3) *Persons under a disability.* A fiduciary acting as the guardian of a minor, or as the guardian or committee of an insane person, must make the return of income required in respect of such person unless, in the case of a minor, the minor himself makes the return or causes it to be made.

(4) *Corporations.* A receiver, trustee in dissolution, trustee in bankruptcy, or assignee, who, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns. Such return shall be filed whether or not the receiver, trustee, or assignee is operating the property or business of the corporation. A receiver in charge of only a small part of the property of a corporation, such as a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make the return of income. See also § 1.6041–1, relating to information at source, and § 1.6042–1, relating to returns regarding corporate dividends, earnings, and profits.

(5) *Individuals in receivership.* A receiver who stands in the place of an individual must make the return of income required in respect of such individual. A receiver of only part of the property of an individual need not file a return, and the individual must make his own return.

(c) *Joint fiduciaries.* In the case of joint fiduciaries, a return is required to be made by only one of such fiduciaries. A return made by one of joint fiduciaries shall contain a statement that the fiduciary has sufficient knowledge of the affairs of the person for whom the return is made to enable him to make the return, and that the return is, to the best of his knowledge and belief, true and correct.

(d) *Other provisions.* For the definition of the term "fiduciary", see section 7701(a)(6) and the regulations thereunder. For information returns required to be made by fiduciaries under section 6041, see § 1.6041–1. As to further duties and liabilities of fiduciaries, see section 6903 and § 301.6903–1 of this chapter (Regulations on Procedure and Administration).

§ 1.6012–4 Miscellaneous returns.

For returns by regulated investment companies of tax on undistributed capital gain designated for special treatment under section 852(b)(3)(D), see § 1.852–9. For returns with respect to tax withheld from nonresident aliens and foreign corporations, and on tax-free covenant bonds, see §§ 1.1461–1 to 1.1461–3, inclusive. For returns of tax on transfers to avoid income tax, see § 1.1494–1. For the requirement of an annual report by persons completing a Government contract, see 26 CFR (1939) 17.16 (Treasury Decision 4906, approved June 23, 1939), and 26 CFR (1939) 16.15 (Treasury Decision 4909, approved June 28, 1939), as made applicable to section 1471 of the 1954 Code by Treasury Decision 6091, approved August 16, 1954 (19 F.R. 5167, C.B. 1954–2, 47).

§ 1.6013 Statutory provisions; joint returns of income tax by husband and wife.

SEC. 6013. *Joint returns of income tax by husband and wife*—(a) *Joint returns.* A husband and wife may make a single return jointly of income taxes under subtitle A, even though one of the spouses has neither gross income nor deductions, except as provided below:

(1) No joint return shall be made if either the husband or wife at any time during the taxable year is a nonresident alien;

(2) No joint return shall be made if the husband and wife have different taxable years; except that if such taxable years begin on the same day and end on different days because of the death of either or both, then the joint return may be made with respect to the taxable year of each. The above exception shall not apply if the surviving spouse remarries before the close of his taxable year, nor if the taxable year of either spouse is a fractional part of a year under section 443(a)(1);

(3) In the case of death of one spouse or both spouses the joint return with respect to the decedent may be made only by his executor or administrator; except that in the case of the death of one spouse the joint return may be made by the surviving spouse with respect to both himself and the decedent if no return for the taxable year has been made by the decedent, no executor or administrator has been appointed, and no executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse. If an executor or administrator of the decedent is appointed after the making of the joint return by the surviving spouse, the executor or administrator may disaffirm such joint return by making, within 1 year after the last day prescribed by law for filing the return of the surviving spouse, a separate return for the taxable year of the decedent with respect to which the joint return was made, in which case the return made by the survivor shall constitute his separate return.

(b) *Joint return after filing separate return*—(1) *In general.* Except as provided in paragraph (2), if an individual has filed a separate return for a taxable year for which a joint return could have been made by him and his spouse under subsection (a) and the time prescribed by law for filing the return for such taxable year has expired, such individual and his spouse may nevertheless make a joint return for such taxable year. A joint return filed by the husband and wife under this subsection shall constitute the return of the husband and wife for such taxable year, and all payments, credits, refunds, or other repayments made or allowed with respect to the separate return of either spouse for such taxable year shall be taken into account in determining the extent to which the tax based upon the joint return has been paid. If a joint return is made under this subsection, any election (other than the election to file a separate return) made by either spouse in his separate return for such taxable year with respect to the treatment of any income, deduction, or credit of such spouse shall not be changed in the making of the joint return where such election would have been irrevocable if the joint return had not been made. If a joint return is made under this subsection after the death of either spouse, such return with respect to the decedent can be made only by his executor or administrator.

(2) *Limitations for making of election.* The election provided for in paragraph (1) may not be made—

(A) Unless there is paid in full at or before the time of the filing of the joint return the amount shown as tax upon such joint return; or

(B) After the expiration of 3 years from the last date prescribed by law for filing the return for such taxable year (determined without regard to any extension of time granted to either spouse); or

(C) After there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under section 6212, if the spouse, as to such notice, files a petition with the Tax Court of the United States within the time prescribed in section 6213; or

(D) After either spouse has commenced a suit in any court for the recovery of any part of the tax for such taxable year; or

(E) After either spouse has entered into a closing agreement under section 7121 with respect to such taxable year, or after any civil or criminal case arising against either spouse with respect to such taxable year has been compromised under section 7122.

(3) *When return deemed filed*—(A) *Assessment and collection.* For purposes of section 6501 (relating to periods of limitations on assessment and collection), and for purposes of section 6651 (relating to delinquent returns), a joint return made under this subsection shall be deemed to have been filed—

(i) Where both spouses filed separate returns prior to making the joint return—on the date the last separate return was filed (but not earlier than the last date prescribed by law for filing the return of either spouse);

(ii) Where only one spouse filed a separate return prior to the making of the joint return, and the other spouse had less than $600 of gross income ($1,200 in case such spouse was 65 or over) for such taxable year—on the date of the filing of such separate return (but not earlier than the last date prescribed by law for the filing of such separate return); or

(iii) Where only one spouse filed a separate return prior to the making of the joint return, and the other spouse had gross income of $600 or more ($1,200 in case such spouse was 65 or over) for such taxable year—on the date of the filing of such joint return.

(B) *Credit or refund.* For purposes of section 6511, a joint return made under this subsection shall be deemed to have been filed on the last date prescribed by law for filing the return for such taxable year (determined without regard to any extension of time granted to either spouse).

(4) *Additional time for assessment.* If a joint return is made under this subsection, the periods of limitations provided in sections 6501 and 6502 on the making of assessments and the beginning of levy or a proceeding in court for collection shall with respect to such return include one year immediately after the date of the filing of such joint return (computed without regard to the provisions of paragraph (3)).

(5) *Additions to the tax and penalties*—(A) *Additions to the tax.* Where the amount shown as the tax by the husband and wife on a joint return made under this subsection exceeds the aggregate of the amounts shown as the tax upon the separate return of each spouse—

(i) *Negligence.* If any part of such excess is attributable to negligence or intentional disregard of rules and regulations (but without intent to defraud) at the time of the making of such separate return, then 5 percent of the total amount of such excess shall be added to the tax;

(ii) *Fraud.* If any part of such excess is attributable to fraud with intent to evade tax at the time of the making of such separate return, then 50 percent of the total amount of such excess shall be added to the tax.

(B) *Criminal penalty.* For purposes of section 7206 (1) and (2) and section 7207 (relating to criminal penalties in the case of fraudulent returns) the term "return" includes a separate return filed by a spouse with respect to a taxable year for which a joint return is made under this subsection after the filing of such separate return.

(c) *Treatment of joint return after death of either spouse.* For purposes of sections 21, 443, and 7851(a)(1)(A), where the husband and wife have different taxable years because of the death of either spouse, the joint return shall be treated as if the taxable years of both spouses ended on the date of the closing of the surviving spouse's taxable year.

(d) *Definitions.* For purposes of this section—

(1) The status as husband and wife of two individuals having taxable years beginning on the same day shall be determined—

(A) If both have the same taxable year—as of the close of such year; and

(B) If one dies before the close of the taxable year of the other—as of the time of such death; and

(2) An individual who is legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married; and

(3) If a joint return is made, the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several.

[Sec. 6013 as amended by sec. 73, Technical Amendments Act 1958 (72 Stat. 1660)]

§ 1.6013–1 Joint returns.

(a) *In general.* (1) A husband and wife may elect to make a joint return under section 6013(a) even though one of the spouses has no gross income or deductions. For rules for determining whether individuals occupy the status of husband and wife for purposes of filing a joint return, see paragraph (a) of § 1.6013–4. For any taxable year with respect to which a joint return has been filed, separate returns shall not be made by the spouses after the time for filing the return of either has expired. See, however, paragraph (d)(5) of this section for the right of an executor to file a late separate return for a deceased spouse and thereby disaffirm a timely joint return made by the surviving spouse.

(2) A joint return of a husband and wife (if not made by an agent) shall be signed by both spouses. The provisions of paragraph (a) (5) of § 1.6012–1, relating to returns made by agents, shall apply where one spouse signs a return as agent for the other, or where a third party signs a return as agent for both spouses.

(b) *Nonresident alien.* A joint return shall not be made if either the husband or wife at any time during the taxable year is a nonresident alien.

(c) *Different taxable years.* Except as otherwise provided in this section, a husband and wife shall not file a joint return if they have different taxable years.

(d) *Joint return after death.* (1) Section 6013 (a)(2) provides that a joint return may be made for the survivor and the deceased spouse or for both deceased spouses if the taxable years of such spouses begin on the same day and end on different days only because of the death of either or both. Thus, if a husband and wife make their returns on a calendar year basis, and the wife dies on August 1, 1956, a joint return may be made with respect to the calendar year 1956 of the husband and the taxable year of the wife beginning on January 1, 1956, and ending with her death on August 1, 1956. Similarly, if husband and wife both make their returns on the basis of a fiscal year beginning on July 1 and the wife dies on October 1, 1956, a joint return may be made with respect to the fiscal year of the husband beginning on July 1, 1956, and ending on June 30, 1957, and with respect to the taxable year of the wife beginning on July 1, 1956, and ending with her death on October 1, 1956.

(2) The provision allowing a joint return to be made for the taxable year in which the death of either or both spouses occurs is subject to two limitations. The first limitation is that if the surviving spouse remarries before the close of his taxable year, he shall not make a joint return with the first spouse who died during the taxable year. In such a case, however, the surviving spouse may make a joint return with his new spouse provided the other requirements with respect to the filing of a joint return are met. The second limitation is that the surviving spouse shall not make a joint return with the deceased spouse if the taxable year of either spouse is a fractional part of a year under section 443 (a)(1) resulting from a change of accounting period. For example, if a husband and wife make their returns on the calendar year basis and the wife dies on March 1, 1956, and thereafter the husband receives permission to change his annual accounting period to a fiscal year beginning July 1, 1956, no joint return shall be made for the short taxable year ending June 30, 1956. Similarly, if a husband and wife who make their returns on a calendar year basis receive permission to change to a fiscal year beginning July 1, 1956, and the wife dies on June 1, 1956, no joint return shall be made for the short taxable year ending June 30, 1956.

(3) Section 6013 (a)(3) provides for the method of making a joint return in the case of the death of one spouse or both spouses. The general rule is that, in the case of the death of one spouse, or of both spouses, the joint return with respect to the decedent may be made only by his executor or administrator, as defined in paragraph (c) of § 1.6013–4. An exception is made to this general rule whereby, in the case of the death of one spouse, the joint return may be made by the surviving spouse with respect to both him and the decedent if all the following conditions exist:

(i) No return has been made by the decedent for the taxable year in respect of which the joint return is made;

(ii) No executor or administrator has been appointed at or before the time of making such joint return; and

(iii) No executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse.

These conditions are to be applied with respect to the return for each of the tax-

able years of the decedent for which a joint return may be made if more than one such taxable year is involved. Thus, in the case of husband and wife on the calendar year basis, if the wife dies in February 1957, a joint return for the husband and wife for 1956 may be made if the conditions set forth in this subparagraph are satisfied with respect to such return. A joint return also may be made by the survivor for both himself and the deceased spouse for the calendar year 1957 if it is separately determined that the conditions set forth in this subparagraph are satisfied with respect to the return for such year. If, however, the deceased spouse should, prior to her death, make a return for 1956, the surviving spouse may not thereafter make a joint return for himself and the deceased spouse for 1956.

(4) If an executor or administrator is appointed at or before the time of making the joint return or before the last day prescribed by law for filing the return of the surviving spouse, the surviving spouse cannot make a joint return for himself and the deceased spouse whether or not a separate return for the deceased spouse is made by such executor or administrator. In such a case, any return made solely by the surviving spouse shall be treated as his separate return. The joint return, if one is to be made, must be made by both the surviving spouse and the executor or administrator. In determining whether an executor or administrator is appointed before the last day prescribed by law for filing the return of the surviving spouse, an extension of time for making the return is included.

(5) If the surviving spouse makes the joint return provided for in subparagraph (3) of this paragraph and thereafter an executor or administrator of the decedent is appointed, the executor or administrator may disaffirm such joint return. This disaffirmance, in order to be effective, must be made within one year after the last day prescribed by law for filing the return of the surviving spouse (including any extension of time for filing such return) and must be made in the form of a separate return for the taxable year of the decedent with respect to which the joint return was made. In the event of such proper disaffirmance the return made by the survivor shall constitute his separate return, that is, the joint return made by him shall be treated as his return and the tax thereon shall be computed by excluding all items properly includible in the return of the deceased spouse. The separate return made by the executor or administrator shall constitue the return of the deceased spouse for the taxable year.

(6) The time allowed the executor or administrator to disaffirm the joint return by the making of a separate return does not establish a new due date for the return of the deceased spouse. Accordingly, the provisions of sections 6651 and 6601, relating to delinquent returns and delinquency in payment of tax, are applicable to such return made by the executor in disaffirmance of the joint return.

(e) *Return of surviving spouse treated as joint return.* For provisions relating to the treatment of the return of a surviving spouse as a joint return for each of the next two taxable years following the year of the death of the spouse, see section 2 and § 1.2–2.

§ 1.6013–2 Joint return after filing separate return.

(a) *In general.* (1) Where an individual has filed a separate return for a taxable year for which a joint return could have been made by him and his spouse under section 6013(a), and the time prescribed by law for filing the return for such taxable year has expired, such individual and his spouse may, under conditions hereinafter set forth, make a joint return for such taxable year. The joint return filed pursuant to section 6013(b) shall constitute the return of the husband and wife for such year, and all payments, credits, refunds, or other repayments, made or allowed with respect to the separate return of either spouse are to be taken into account in determining the extent to which the tax based on the joint return has been paid.

(2) If a joint return is made under section 6013(b), any election, other than the election to file a separate return, made by either spouse in his separate return for the taxable year with respect to the treatment of any income, deduction, or credit of such spouse shall not be changed in the making of the joint return where such election would have been irrevocable if the joint return had not been made. Thus, if one spouse has made an irrevocable election to adopt and use the last-in, first-out inventory method under section 472, this election may not be changed upon making the joint return under section 6013(b).

(3) A joint return made under section 6013(b) after the death of either spouse shall, with respect to the decedent, be made only by his executor or administrator. Thus, where no executor or administrator has been appointed, a joint return cannot be made under section 6013(b).

(b) *Limitations with respect to making of election.* A joint return shall not be made under section 6013(b)(1) with respect to a taxable year—

(1) Unless there is paid in full at or before the time of the filing of the joint return the amount shown as tax upon such joint return; or

(2) After the expiration of three years from the last day prescribed by law for filing the return for such taxable year determined without regard to any extension of time granted to either spouse; or

(3) After there has been mailed to either spouse, with respect to such taxable year, a notice of deficiency under section 6212, if the spouse, as to such notice, files a petition with the Tax Court of the United States within the time prescribed in section 6213; or

(4) After either spouse has commenced a suit in any court for the recovery of any part of the tax for such taxable year; or

(5) After either spouse has entered into a closing agreement under section 7121 with respect to such taxable year, or after any civil or criminal case arising against either spouse with respect to such taxable year has been compromised under section 7122.

(c) *When return deemed filed; assessment and collection; credit or refund.* (1) For the purpose of section 6501, relating to the period of limitations upon assessment and collection, and section 6651, relating to delinquent returns, a joint return made under section 6013(b) shall be deemed to have been filed, giving due regard to any extension of time granted to either spouse, on the following date:

(i) Where both spouses filed separate returns, prior to making the joint return under section 6013(b), on the date the last separate return of either spouse was filed for the taxable year, but not earlier than the last date prescribed by law for the filing of the return of either spouse;

(ii) Where only one spouse was required and did file a return prior to the making of the joint return under section 6013(b), on the date of the filing of the separate return, but not earlier than the last day prescribed by law for the filing of such return; or

(iii) Where both spouses were required to file a return, but only one spouse did so file, on the date of the filing of the joint return under section 6013(b).

(2) For the purpose of section 6511, relating to refunds and credits, a joint return made under section 6013(b) shall be deemed to have been filed on the last date prescribed by law for filing the return for such taxable year, determined without regard to any extension of time granted to either spouse for filing the return or paying the tax.

(d) *Additional time for assessment.* In the case of a joint return made under section 6013(b), the period of limitations provided in sections 6501 and 6502 shall not be less than one year after the date of the actual filing of such joint return. The expiration of the one year is to be determined without regard to the rules provided in paragraph (c)(1) of this section, relating to the application of sections 6501 and 6651 with respect to a joint return made under section 6013(b).

(e) *Additions to the tax and penalties.* (1) Where the amount shown as the tax by the husband and wife on a joint return made under section 6013(b) exceeds the aggregate of the amounts shown as tax on the separate return of each spouse, and such excess is attributable to negligence, intentional disregard of rules and regulations, or fraud at the time of the making of such separate return, there shall be assessed, collected, and paid in the same manner as if it were a deficiency an additional amount as provided by the following:

(i) If any part of such excess is attributable to negligence, or intentional disregard of rules and regulations, at the time of the making of such separate return, but without any intent to defraud, this additional amount shall be 5 percent of the total amount of the excess.

(ii) If any part of such excess is attributable to fraud with intent to evade tax at the time of the making of such

separate return, this additional amount shall be 50 percent of the total amount of the excess. The latter addition is in lieu of the 50 percent addition to the tax provided in section 6653(b).

(2) For purposes of section 7206 (1) and (2) and section 7207 (relating to criminal penalties in the case of fraudulent returns), the term "return" includes a separate return filed by a spouse with respect to a taxable year for which a joint return is made under section 6013 (b) after the filing of a separate return.

§ 1.6013–3 Treatment of joint return after death of either spouse.

For purposes of section 21 (relating to change in rates during a taxable year), section 443 (relating to returns for a period of less than 12 months), and section 7851(a)(1)(A) (relating to the applicability of certain provisions of the Internal Revenue Code of 1954 and the Internal Revenue Code of 1939), where the husband and wife have different taxable years because of death of either spouse, the joint return shall be treated as if the taxable years of both ended on the date of the closing of the surviving spouse's taxable year. Thus, in cases where the Internal Revenue Code of 1939 otherwise would apply to the taxable year of the decedent spouse and the Internal Revenue Code of 1954 would apply to the taxable year of the surviving spouse, this provision makes the Internal Revenue Code of 1954 applicable to the taxable years of both spouses if a joint return is filed.

§ 1.6013–4 Applicable rules.

(a) *Status as husband and wife.* For the purpose of filing a joint return under section 6013, the status as husband and wife of two individuals having taxable years beginning on the same day shall be determined—

(1) If the taxable year of each individual is the same, as of the close of such year; and

(2) If the close of the taxable year is different by reason of the death of one spouse, as of the time of such death.

An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married. However, the mere fact that spouses have not lived together during the course of the taxable year shall not prohibit them from making a joint return. A husband and wife who are separated under an interlocutory decree of divorce retain the relationship of husband and wife until the decree becomes final. The fact that the taxpayer and his spouse are divorced or legally separated at any time after the close of the taxable year shall not deprive them of their right to file a joint return for such taxable year under section 6013.

(b) *Computation of income, deductions, and tax.* If a joint return is made, the gross income and adjusted gross income of husband and wife on the joint return are computed in an aggregate amount and the deductions allowed and the taxable income are likewise computed on an aggregate basis. Deductions limited to a percentage of the adjusted gross income, such as the deduction for charitable, etc., contributions and gifts, under section 170, will be allowed with reference to such aggregate adjusted gross income. A similar rule is applied in the case of the limitation of section 1211(b) on the allowance of losses resulting from the sale or exchange of capital assets (see § 1.1211–1). Although there are two taxpayers on a joint return, there is only one taxable income. The tax on the joint return shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several. For computation of tax on the basis of the splitting of income in the case of a joint return, see § 1.2–1. For tax in the case of a joint return of husband and wife electing to pay the optional tax under section 3, see § 1.3–1 and paragraph (c) of § 1.6014–1. For separate computations of the self-employment tax of each spouse on a joint return, see paragraph (b) of § 1.6017–1.

(c) *Definition of executor or administrator.* For purposes of section 6013 the term "executor or administrator" means the person who is actually appointed to such office and not a person who is merely in charge of the property of the decedent.

§ 1.6014 Statutory provisions; income tax return—tax not computed by taxpayer.

SEC. 6014. *Income tax return—tax not computed by taxpayer*—(a) *Election by taxpayer.* An individual entitled to elect to pay the tax imposed by section 3 whose gross income is less than $5,000 and includes no income other than remuneration for services performed by him as an employee, dividends or interest, and whose gross income other than wages, as defined in section 3401 (a), does not exceed $100, shall at his election not be required to show on the return the tax imposed by section 1. Such election shall be made by using the form prescribed for purposes of this section and shall constitute an election to pay the tax imposed by section 3. In such case the tax shall be computed by the Secretary or his delegate who shall mail to the taxpayer a notice stating the amount determined as payable. In determining the amount payable, the credit against such tax provided for by section 34 or 37 shall not be allowed. In the case of a head of household (as defined in section 1(b)) or a surviving spouse (as defined in section 2(b)) electing the benefits of this subsection, the tax shall be computed by the Secretary or his delegate without regard to the taxpayer's status as a head of household or as a surviving spouse.

(b) *Regulations.* The Secretary or his delegate shall prescribe regulations for carrying out this section, and such regulations may provide for the application of the rules of this section to cases where the gross income includes items other than those enumerated by subsection (a), to cases where the gross income from sources other than wages on which the tax has been withheld at the source is more than $100 but not more than $200, and to cases where the gross income is $5,000 or more but not more than $5,200. Such regulations shall provide for the application of this section in the case of husband and wife, including provisions determining when a joint return under this section may be permitted or required, whether the liability shall be joint and several, and whether one spouse may make return under this section and the other without regard to this section.

§ 1.6014–1 Tax not computed by taxpayer with gross income less than $5,000.

(a) *In general.* If an individual is entitled under paragraph (a)(7) of § 1.6012–1 to use as his return Form 1040A, he may elect not to show thereon the amount of the tax due in connection with such return if his gross income is less than $5,000.

(b) *Computation and payment of tax.* A taxpayer who, in accordance with paragraph (a) of this section, elects not to show the tax on Form 1040A is not required to pay the unpaid balance of such tax at the time he files the return. In such case, the tax will be computed for the taxpayer by the Internal Revenue Service, and a notice will be mailed to the taxpayer stating the amount of tax due. Where it is determined that a refund of tax is due, the Internal Revenue Service will send such refund to the taxpayer. See paragraph (c) of § 301.6402–3 of this chapter (Regulations on Procedure and Administration).

(c) *Joint return.* (1) A husband and wife who, pursuant to paragraphs (a)(7) and (10) of § 1.6012–1, file a joint return on Form 1040A may elect not to show the tax on such return if their aggregate gross income for the taxable year is less than $5,000.

(2) The tax computed for the taxpayer who files Form 1040A and elects not to show thereon the tax due shall be the lesser of the following amounts:

(i) A tax computed as though the return on Form 1040A constituted the separate returns of the spouses, or

(ii) A tax computed as though the return on Form 1040A constituted a joint return.

§ 1.6015(a) Statutory provisions; declaration of estimated income tax by individuals; requirement of declaration.

SEC. 6015. *Declaration of estimated income tax by individuals*—(a) *Requirement of declaration.* Every individual (other than a nonresident alien with respect to whose wages, as defined in section 3401 (a), withholding under chapter 24 is not made applicable, but including every alien individual who is a resident of Puerto Rico during the entire taxable year) shall make a declaration of his estimated tax for the taxable year if—

(1) The gross income for the taxable year can reasonably be expected to consist of wages (as defined in section 3401 (a)) and of not more than $100 from sources other than such wages, and can reasonably be expected to exceed—

(A) $5,000, in the case of a single individual other than a head of a household (as defined in section 1 (b) (2)) or a surviving spouse (as defined in section 2 (b)) or in the case of a married individual not entitled to file a joint declaration with his spouse;

(B) $10,000, in the case of a head of a household (as defined in section 1 (b) (2)) or a surviving spouse (as defined in section 2 (b)); or

(C) $5,000, in the case of a married individual entitled under subsection (b) to file a joint declaration with his spouse, and the aggregate gross income of such individual and his spouse for the taxable year can reasonably be expected to exceed $10,000; or

(2) The gross income can reasonably be expected to include more than $100 from sources other than wages (as defined in section 3401 (a)) and can reasonably be expected to exceed the sum of—

(A) The amount obtained by multiplying $600 by the number of exemptions to which he is entitled under section 151 plus
(B) $400.

§ 1.6015(a)–1 Declaration of estimated income tax by individuals.

(a) *Requirement.* A declaration of estimated tax shall be made by every citizen of the United States, whether residing at home or abroad, every individual residing in the United States though not a citizen thereof, every nonresident alien who is a resident of Canada, Mexico, or Puerto Rico and who has wages subject to withholding at the source under section 3402, and every nonresident alien who has been, or expects to be, a resident of Puerto Rico during the entire taxable year, if—

(1) The gross income for the taxable year can reasonably be expected to consist of wages (as defined in section 3401 (a)) and of not more than $100 from sources other than such wages, and can reasonably be expected to exceed—

(i) $5,000, in the case of a single individual other than a head of a household (as defined in section 1 (b) (2)) or a surviving spouse (as defined in section 2 (b)) or in the case of a married individual not entitled to file a joint declaration with his spouse;

(ii) $10,000, in the case of a head of a household (as defined in section 1 (b) (2)) or a surviving spouse (as defined in section 2 (b)); or

(iii) $5,000, in the case of a married individual entitled under section 6015 (b) to file a joint declaration with his spouse, and the aggregate gross income of such individual and his spouse for the taxable year can reasonably be expected to exceed $10,000; or

(2) The gross income can reasonably be expected to include more than $100 from sources other than wages (as defined in section 3401 (a)) and can reasonably be expected to exceed the sum of—

(i) The amount obtained by multiplying $600 by the number of exemptions to which he is entitled under section 151 plus

(ii) $400.

(b) *Income of child.* In estimating his gross income for the taxable year a parent should not take into account the income of his minor child. Such income is not includible in the gross income of the parent. See section 73 and § 1.73–1.

(c) *Exemption of spouse.* For the purpose of determining whether a declaration of estimated tax is required under the provisions of paragraph (a) (2) of this section, a married person filing a separate declaration may not take into account the exemption of his spouse, if his spouse has, or is reasonably expected to have, gross income, or is reasonably expected to be the dependent of another taxpayer, for the taxable year.

(d) *Nonresident aliens.* (1) A nonresident alien who is—

(i) A resident of Canada or Mexico and enters and leaves the United States at frequent intervals, or

(ii) A resident of Puerto Rico,

and who has wages subject to withholding under section 3402, is required to file a declaration of estimated tax if his gross income meets the requirements of section 6015 (a). In the case of a nonresident alien (other than an alien resident of Puerto Rico for the entire taxable year) gross income means only gross income from sources within the United States. See sections 872 and 876 and the regulations thereunder. As to what constitutes gross income from sources within the United States, see sections 861 to 864, inclusive, and the regulations thereunder. Thus, for example, a nonresident alien, living in Mexico with his wife throughout 1955, makes his return on a calendar year basis. His wife is also a nonresident alien. He is employed as an executive in El Paso, Texas, at a salary of $8,000 per annum and enters and leaves the United States at frequent intervals in pursuit of such employment. He has no reasonable expectation of any other income from United States sources. Since the gross income of such individual derived from sources within the United States in 1955 can reasonably be expected to amount to more than $5,000 (married individual not entitled to file a joint declaration with his spouse), a declaration of estimated tax must be made by such resident of Mexico for 1955.

(2) A nonresident alien who has been, or expects to be, a resident of Puerto Rico during the entire taxable year is required to file a declaration of estimated tax if his gross income meets the requirements of section 6015 (a). For the purpose of such declaration, gross income means gross income from all sources, other than sources within Puerto Rico (but including amounts received for services performed within Puerto Rico as an employee of the United States or any agency thereof). See sections 876 and 933 and the regulations thereunder.

(e) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). H maintains as his home a household which is the principal place of abode of himself and his two dependent children. H's wife died in 1953 and he has not remarried. H and his wife filed a joint return for 1953. H's salary from January 1 to June 30, 1955, is at the annual rate of $9,000. However, effective July 1, 1955, his annual salary is increased to $12,000, and under the facts then existing it is reasonable to assume that his salary for the remaining portion of 1955 will remain unchanged and that his total salary for the year will, therefore, be $10,500. Since H is a surviving spouse (as defined in section 2(b)) and his gross income can reasonably be expected to exceed $10,000, he is required to file a declaration of estimated tax for 1955. As to when such declaration must be filed, see section 6073 and §§ 1.6073–1 to 1.6073–4, inclusive.

Example (2). P, a taxpayer making his return on the calendar year basis, is married and has two dependent children. Neither his wife nor his children have any source of income. P is engaged in the practice of his profession on his own account and has gross income of $600 from such profession for the two months of January and February 1955. He reasonably expects that his gross income from his profession will continue to average $300 each month throughout the year and that he will have no income from any other source during 1955. Since P has gross income which can for 1955 reasonably be expected to exceed $2,800 ($2,400 for four exemptions plus $400), and such income does not constitute wages subject to withholding, he is required to file a declaration of estimated tax for that year.

Example (3). S, a married taxpayer, has been regularly employed for many years prior to January 1, 1955, at which date his weekly wage is $75. Neither his wife nor his two children have any source of income. S also owns stock in a corporation from which he has derived regularly for many years prior to 1955, annual dividends ranging from $150 to $175. In view of the fact that his gross income can reasonably be expected to include more than $100 from sources other than wages, and can reasonably be expected to exceed $600 multiplied by his four personal exemptions plus $400, or $2,800, S is required to make a declaration of estimated tax for 1955.

Example (4). H and W, husband and wife, derive their income from wages. Their joint savings account nets them less than $50 in interest each year. During 1955, H expects to receive wages of $7,500, and W expects to receive wages of $4,500. A declaration is required for 1955 since the aggregate gross income of H and W can be expected to exceed $10,000. In the event H and W do not file a joint declaration, a separate declaration must be filed by H since his gross income can reasonably be expected to exceed $5,000 and the aggregate gross income of H and W can reasonably be expected to exceed $10,000.

(f) *Declarations made by agents.* The declaration may be made by an agent if, by reason of illness, the person liable for the making of the declaration is unable to make it. The declaration may also be made by an agent if the taxpayer is unable to make the declaration by reason of continuous absence from the United States (including Puerto Rico as if a part of the United States) for a period of at least 60 days prior to the date prescribed by law for making the declaration. Whenever a declaration is made by an agent it must be accompanied by the prescribed power of attorney, Form 935, except that an agent holding a valid and subsisting general power of attorney authorizing him to represent his principal in making, executing, and filing the declaration, may submit a certified copy thereof in lieu of the authorization on Form 935. The taxpayer and his agent, if any, are responsible for the declaration as made and incur liability for the penalties provided for erroneous, false, or fraudulent declarations.

§ 1.6015(b) Statutory provisions; declaration of estimated income tax by individuals; joint declaration by husband and wife.

SEC. 6015. *Declaration of estimated income tax by individuals.* * * *

(b) *Joint declaration by husband and wife.* In the case of a husband and wife, a single declaration under this section may be made by them jointly, in which case the liability with respect to the estimated tax shall be joint and several. No joint declaration may be made if either the husband or the wife is a nonresident alien, if they are separated under a decree of divorce or of separate maintenance, or if they have different taxable years. If a joint declaration is made but a joint return is not made for the taxable year, the estimated tax for such year may be treated as the estimated tax of either the husband or the wife, or may be divided between them.

§ 1.6015(b)–1 Joint declaration by husband and wife.

(a) *In general.* A husband and wife may make a joint declaration of estimated tax even though they are not living together. However, a joint declaration may not be made if they are separated under a decree of divorce or of separate maintenance. A joint declaration may not be made if the taxpayer's spouse is a nonresident alien (including a nonresident alien who is a bona fide resident of Puerto Rico during the entire taxable year) or if his spouse has a different taxable year. If the gross income of each spouse meets the requirements of section 6015 (a), either a joint declaration must be made or a separate declaration must be made by each. For computation of tax in case of a joint return, see § 1.2–1. If a joint declaration is made by husband and wife, the liability with respect to the estimated tax shall be joint and several.

(b) *Application to separate returns.* The fact that a joint declaration of estimated tax is made by them will not preclude a husband and his wife from filing separate returns. In case a joint declaration is made but a joint return is not made for the same taxable year, the payments made on account of the estimated tax for such year may be treated as payments on account of the tax liability of either the husband or wife for the taxable year or may be divided between them in such manner as they may agree. In the event the husband and wife fail to agree to a division, such payments shall be allocated between them in accordance with the following rule. The portion of such payments to be allocated to a spouse shall be that portion of the aggregate of all such payments as the amount of tax shown on the separate return of the taxpayer bears to the sum of the taxes shown on the separate returns of the taxpayer and his spouse.

(c) *Death of spouse.* (1) A joint declaration may not be made after the death of either the husband or wife. However, if it is reasonable for a surviving spouse to assume that there will be filed a joint return for himself and the deceased spouse for his taxable year and the last taxable year of the deceased spouse he may, in making a separate declaration for his taxable year which includes the period comprising such last taxable year of his spouse, estimate taxable income on an aggregate basis and compute his estimated tax in the same manner as though a joint declaration had been filed.

(2) If a joint declaration is made by husband and wife and thereafter one spouse dies, no further payments of estimated tax on account of such joint declaration are required from the estate of the decedent. The surviving spouse, however, shall be liable for the payment of any subsequent installments of the joint estimated tax unless an amended declaration setting forth the separate estimated tax for the taxable year is made by such spouse. Such separate estimated tax shall be paid at the times and in the amounts determined under the rules prescribed in section 6153. For the purpose of (i) such amended declaration by the surviving spouse, and (ii) allocating the payments made pursuant to the joint declaration between the surviving spouse and the legal representative of the decedent in the event a joint return is not filed, the payments made pursuant to the joint declaration may be divided between the decedent and the surviving spouse in such proportion as the surviving spouse and the legal representative of the decedent may agree. In the event the surviving spouse and the legal representative of the decedent fail to agree to a division, such payments shall be allocated in accordance with the following rule. The portion of such payments to be allocated to the surviving spouse shall be that portion of the aggregate amount of such payments as the amount of tax shown on the separate return of the surviving spouse bears to the sum of the taxes shown on the separate returns of the surviving spouse and of the decedent, and the balance of such payments shall be allocated to the decedent.

(d) *Signing of declaration.* A joint declaration of a husband and wife shall be signed by both spouses or, if signed by one spouse as agent for the other, authorization must accompany the declaration. Both spouses, whether or not one acts as agent for the other, are responsible for making the declaration and incur liability for the penalties provided for erroneous, false, or fraudulent declarations. For provisions relating to the making of declarations by agents, see paragraph (f) of § 1.6015 (a)–1.

§ 1.6015(c) Statutory provisions; declaration of estimated income tax by individuals; estimated tax.

SEC. 6015. *Declaration of estimated income tax by individuals.* * * *

(c) *Estimated tax.* For purposes of this title, in the case of an individual, the term "estimated tax" means the amount which the individual estimates as the amount of the income tax imposed by chapter 1 for the taxable year, minus the amount which the individual estimates as the sum of any credits against tax provided by part IV of subchapter A of chapter 1.

§ 1.6015(c)–1 Definition of estimated tax.

In the case of an individual, the term "estimated tax" means the amount which the individual estimates as the amount of the income tax imposed by chapter 1 of the Code for the taxable year, minus the amount which he estimates as the sum of the credits against tax provided by part IV, subchapter A of such chapter. These credits are those provided by section 31 (relating to tax withheld on wages), section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds), section 33 (relating to foreign taxes), section 34 (relating to dividends received), section 35 (relating to partially tax-exempt interest), and section 37 (relating to retirement income). An individual who expects to elect to pay the optional tax imposed by section 3, or one who expects to elect to take the standard deduction allowed by section 144, should disregard any credits otherwise allowable under sections 32, 33, and 35 in computing his estimated tax since, if he so elects, these credits are not allowed in computing his tax liability. See section 36.

§ 1.6015(d) Statutory provisions; declaration of estimated income tax by individuals; contents of declaration.

SEC. 6015. *Declaration of estimated income tax by individuals.* * * *

(d) *Contents of declaration.* The declaration shall contain such pertinent information as the Secretary or his delegate may by forms or regulations prescribe.

§ 1.6015(d)–1 Contents of declaration of estimated tax.

(a) *In general.* (1) The declaration of estimated tax by an individual shall be made on Form 1040–ES. For the purpose of making the declaration, the amount of gross income which the taxpayer can reasonably be expected to receive or accrue, depending upon the method of accounting upon which taxable income is computed, and the amount of the estimated allowable deductions and credits to be taken into account in computing the amount of estimated tax shall be determined upon the basis of the facts and circumstances existing as at the time prescribed for the filing of the declaration as well as those reasonably to be anticipated for the taxable year. If, therefore, the taxpayer is employed at the date prescribed for filing his declaration at a given wage or salary, it should, in the absence of circumstances indicating the contrary, be presumed by him for the purpose of the declaration that such employment will continue to the end of the taxable year at the wage or salary received by him as of such date. In the case of income other than wages and salary the regularity in the payment of income, such as dividends, interest, rents, royalties, and income arising from estates and trusts is a factor to be taken into consideration. Thus, if the taxpayer owns shares of stock in a corporation and dividends have been paid regularly for several years upon such stock, the taxayer in the preparation of his declaration should, in the absence of information indicating a change in the dividend policy, include the prospective dividends from the corporation for the taxable year as well as those actually received in such year prior to the filing of the declaration. In the case of a taxpayer engaged in business on his own account, there shall be made an estimate of gross income and deductions and credits in the light of the best available information affecting the trade, business, or profession.

(2) In the case of any individual who can, at the time of the preparation of his declaration, reasonably anticipate that his gross income will be of such amount and character as to enable him to elect upon his return for such year to compute the tax under section 3 (relating to optional tax), in lieu of the tax imposed by section 1, the declaration of estimated tax may be made upon the basis set forth in section 3 and § 1.3–1. The filing of a declaration computed upon the basis of section 3 shall not constitute the making of an election under section 4 (relating to rules for op-

tional tax) nor will it permit the filing of a return on the basis of the optional tax under section 3 unless the taxpayer otherwise comes within the provisions of sections 3 and 4. For the purpose of computing the tax liability in the case of married persons, if the taxable income of one spouse is determined without regard to the standard deduction, the standard deduction is not allowed to either. (See, however, paragraph (c) of § 1.142–1 for exceptions where spouses are legally separated under a decree of divorce or separate maintenance.) Hence, where separate declarations are filed, one spouse should not use section 3 in computing the estimated tax unless the other spouse also uses section 3 or employs the standard deduction in computing the estimated tax.

(b) *Computation of estimated tax.* In computing the estimated tax there shall be shown on the declaration—

(1) The amount estimated as the tax for the taxable year after the application of any amounts estimated as the credit for foreign taxes, the dividends received credit, the retirement income credit, the credit for partially tax-exempt interest, and the credit for tax withheld at source, but without regard to the credit under section 31 for tax withheld on wages;

(2) The amount estimated by the taxpayer as the credit under section 31 for tax withheld on wages; and

(3) The excess, if any, of the amount shown under subparagraph (1) of this paragraph over the amount shown under subparagraph (2) of this paragraph, which excess shall be the estimated tax for such taxable year.

If the taxpayer so desires, he may include in his declaration an amount estimated as the tax on self-employment income imposed by section 1401.

(c) *Use of prescribed form.* Copies of Form 1040–ES will so far as possible be furnished taxpayers by district directors. A taxpayer will not be excused from making a declaration, however, by the fact that no form has been furnished to him. Taxpayers not supplied with the proper form should make application therefor to the district director in ample time to have their declarations prepared, verified, and filed with the district director on or before the date prescribed for filing the declaration. If the prescribed form is not available, a statement disclosing the amount estimated as the tax, the estimated credits, and the estimated tax after deducting such credits should be filed as a tentative declaration within the prescribed time, accompanied by the payment of the required installment. Such tentative declaration should be supplemented, without unnecessary delay, by a declaration made on the proper form.

§ 1.6015(e) Statutory provisions; declaration of estimated income tax by individuals; amendment of declaration.

SEC. 6015. *Declaration of estimated income tax by individuals.* * * *

(e) *Amendment of declaration.* An individual may make amendments of a declaration filed during the taxable year under regulations prescribed by the Secretary or his delegate.

§ 1.6015(e)–1 Amendment of declaration.

In the making of a declaration of estimated tax, the taxpayer is required to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, allowable deductions, and estimated credits for the taxable year. Amended or revised declarations may be made in any case in which the taxpayer estimates that his gross income, deductions, or credits will differ from the gross income, deductions, or credits reflected in the previous declaration. An amended declaration may also be made based upon a change in the number of exemptions to which the taxpayer may be entitled for the then current taxable year. However, only one amended declaration may be filed during any interval between installment dates. See paragraph (d) of § 1.6073–1. An amended declaration may be filed jointly by husband and wife even though separate declarations have previously been filed. An amended declaration may be made on either Form 1040–ES (marked "Amended") or on the reverse side of the Statement of Account or Notice of Payment Due furnished the taxpayer by the district director. See, however, paragraph (c) of § 1.6015 (d)–1 for procedure to be followed if the prescribed form is not available.

§ 1.6015(f) Statutory provisions; declaration of estimated income tax by individuals; return as declaration or amendment.

SEC. 6015. *Declaration of estimated income tax by individuals.* * * *

(f) *Return as declaration or amendment.* If on or before January 31 (or February 15, in the case of an individual referred to in section 6073 (b), relating to income from farming) of the succeeding taxable year the taxpayer files a return, for the taxable year for which the declaration is required, and pays in full the amount computed on the return as payable, then, under regulations prescribed by the Secretary or his delegate—

(1) If the declaration is not required to be filed during the taxable year, but is required to be filed on or before January 15, such return shall be considered as such declaration; and

(2) If the tax shown on the return (reduced by the sum of the credits against tax provided by part IV of subchapter A of chapter 1) is greater than the estimated tax shown in a declaration previously made, or in the last amendment thereof, such return shall be considered as the amendment of the declaration permitted by subsection (e) to be filed on or before January 15.

In the application of this subsection in the case of a taxable year beginning on any date other than January 1, there shall be substituted, for the 15th or last day of the months specified in this subsection, the 15th or last day of the months which correspond thereto.

[Sec. 6015(f) as amended by sec. 74, Technical Amendments Act 1958 (72 Stat. 1660)]

§ 1.6015(f)–1 Return as declaration or amendment.

(a) *Time for filing return.* (1) if the taxpayer files his return for the calendar year on or before January 31 (or February 15, in the case of an individual referred to in section 6073(b), relating to income from farming) of the succeeding calendar year (or if the taxpayer is on a fiscal year basis, on or before the last day of the first month (in the case of a farmer, the 15th day of the second month) immediately succeeding the close of such fiscal year), and pays in full the amount computed on the return as payable, then—

(i) If the declaration is not required to be filed during the taxable year, but is required to be filed on or before January 15 of the succeeding year (or the date corresponding thereto in the case of a fiscal year), such return shall be considered as such declaration; or

(ii) If a declaration was filed during the taxable year, such return shall be considered as the amendment of the declaration permitted by section 6015 (e) to be filed on or before January 15 of the succeeding year (or the date corresponding thereto in the case of a fiscal year). Hence, for example, an individual taxpayer on the calendar year basis who, subsequent to September 1, 1955, first meets the requirements of section 6015 (a) which necessitate the filing of a declaration for 1955, may satisfy the requirements as to the filing of such declaration by filing his return for 1955 on or before January 31, 1956 (February 15, 1956, in the case of a farmer), and paying in full at the time of such filing the tax shown thereon to be payable. Likewise, if a taxpayer files on or before September 15, 1955, a timely declaration for such year and subsequent thereto and on or before January 31, 1956, files his return for 1955, and pays at the time of such filing the tax shown by the return to be payable, such return shall be treated as an amended declaration timely filed.

(2) For the purpose of section 6015 (f) a taxpayer may file his return on or before the last day of the first month following the close of the taxable year even though he has not been furnished Form W–2 by his employer. In such case the taxpayer shall compute, as accurately as possible, his wages for such year and the tax withheld for which he is entitled to a credit, reporting such wages and tax on his return, together with all other pertinent information necessary to the determination of his tax liability for such year.

(b) *Effect on addition to the tax.* Compliance with the provisions of section 6015 (f) will enable a taxpayer to avoid the addition to the tax imposed by section 6654 with respect to an underpayment of the installment not required to be paid until January 15 of the succeeding calendar year (or the corresponding date in the case of a fiscal year). With respect to an underpayment of any earlier installment, compliance with section 6015 (f) will not relieve the taxpayer from the addition to the tax imposed by section 6654. However, the period of the underpayment under section 6654 (c), with respect to any earlier installment, will terminate on January 15 of the succeeding calendar year (or the corresponding date in the case of a fiscal year). For example, a taxpayer discovers on January 14, 1956, that he has underpaid his estimated tax for the calendar year 1955. He may, in lieu of filing an amended declaration on January 15, 1956, and paying the balance of the estimated tax determined thereon, file his final return on

January 31, 1956, and pay in full the amount computed thereon as payable. By so doing, he will avoid the addition to the tax with respect to the underpayment of the installment required to be paid by January 15, 1956. The periods of underpayment, under section 6654 (c), as to the installments required to be paid on April 15, 1955, June 15, 1955, and September 15, 1955, also terminate on January 15, 1956.

§ 1.6015(g) Statutory provisions; declaration of estimated income tax by individuals; short taxable years.

SEC. 6015. *Declaration of estimated income tax by individuals.* * * *

(g) *Short taxable years.* An individual with a taxable year of less than 12 months shall make a declaration in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.6015(g)–1 Short taxable years of individuals.

(a) *Requirement of declaration.* No declaration may be made for a period of more than 12 months. For purposes of this section a taxable year of 52 or 53 weeks, in the case of a taxpayer who computes his taxable income in accordance with the election permitted by section 441(f) shall be deemed a period of 12 months. For special rules affecting the time for filing declarations and paying estimated tax by such a taxpayer, see paragraph (b) of § 1.442–2. A separate declaration for a fractional part of a year is required where, for example, there is a change, with the approval of the Commissioner, in the basis of computing taxable income from one taxable year to another taxable year. The periods to be covered by such separate declarations in the several cases are those set forth in section 443. No declaration is required if the short taxable year is—

(1) A period of less than four months,

(2) A period of at least four months but less than six months and the requirements of section 6015(a) are first met after the 1st day of the fourth month.

(3) A period of at least six months but less than nine months and the requirements of section 6015 (a) are first met after the 1st day of the sixth month, or

(4) A period of nine months or more and the requirements of section 6015 (a) are first met after the 1st day of the ninth month.

In the case of a decedent, no declaration need be filed subsequent to the date of death. As to the requirement for an amended declaration if death of one spouse occurs after filing a joint declaration, see paragraph (c) of § 1.6015 (b)–1.

(b) *Income placed on annual basis.* For the purpose of determining whether the anticipated income for a short taxable year, resulting from a change of annual accounting period, necessitates the filing of a declaration, such income shall be placed on an annual basis in the manner prescribed in section 443 (b) (1). Thus, for example, a taxpayer who changes from a calendar year basis to a fiscal year basis beginning July 1, 1955, will have a short taxable year beginning January 1, 1955, and ending June 30, 1955. If his anticipated gross income for such short taxable year consists solely of wages (as defined in section 3401 (a)) in the amount of $3,000, his total gross income and his gross income from such wages for the purpose of determining whether a declaration is required is $6,000, the amount obtained by placing anticipated income of $3,000 upon an annual basis. Hence, assuming such taxpayer is single, and is not a head of a household or a surviving spouse, he is required to file a declaration of estimated tax for the short taxable year since his anticipated gross income from wages when placed upon an annual basis is in excess of $5,000.

§ 1.6015(h) Statutory provisions; declaration of estimated income tax by individuals; estates and trusts.

SEC. 6015. *Declaration of estimated income tax by individuals.* * * *

(h) *Estates and trusts.* The provisions of this section shall not apply to an estate or trust.

§ 1.6015(h)–1 Estates and trusts.

An estate or trust, though generally taxed as an individual, is not required to file a declaration.

§ 1.6015(i) Statutory provisions; declaration of estimated income tax by individuals; applicability.

SEC. 6015. *Declaration of estimated income tax by individuals.* * * *

(i) *Applicability.* This section shall be applicable only with respect to taxable years beginning after December 31, 1954; and sections 58, 59, and 60 of the Internal Revenue Code of 1939 shall continue in force with respect to taxable years beginning before January 1, 1955.

§ 1.6015(i)–1 Applicability.

Section 6015 is applicable only with respect to taxable years beginning after December 31, 1954. Sections 58, 59, and 60 of the Internal Revenue Code of 1939 and the regulations thereunder, shall continue in force with respect to taxable years beginning before January 1, 1955.

§ 1.6016 Statutory provisions; declarations of estimated income tax by corporations.

SEC. 6016. *Declarations of estimated income tax by corporations*—(a) *Requirement of declaration.* Every corporation subject to taxation under section 11 or 1201 (a), or subchapter L of chapter 1 (relating to insurance companies), shall make a declaration of estimated tax under chapter 1 for the taxable year if its income tax imposed by section 11 or 1201 (a), or such subchapter L, for such taxable year, reduced by the credits against tax provided by part IV of subchapter A of chapter 1, can reasonably be expected to exceed $100,000.

(b) *Estimated tax.* For purposes of this title, in the case of a corporation, the term "estimated tax" means the excess of—

(1) The amount which the corporation estimates as the amount of the income tax imposed by section 11 or 1201 (a), or subchapter L of chapter 1, whichever is applicable, over

(2) the sum of—

(A) $100,000, and

(B) The amount which the corporation estimates as the sum of any credits against tax provided by part IV of subchapter A of chapter 1.

(c) *Contents of declaration.* The declaration shall contain such pertinent information as the Secretary or his delegate may by forms or regulations prescribe.

(d) *Amendment of declaration.* A corporation may make amendments of a declaration filed during the taxable year under regulations prescribed by the Secretary or his delegate.

(e) *Short taxable year.* A corporation with a taxable year of less than 12 months shall make a declaration in accordance with regulations prescribed by the Secretary or his delegate.

(f) *Applicability.* This section shall apply only with respect to taxable years ending on or after December 31, 1955.

§ 1.6016–1 Declarations of estimated income tax by corporations.

(a) *Requirement.* For taxable years ending on or after December 31, 1955, a declaration of estimated tax shall be made by every corporation (including unincorporated business enterprises electing to be taxed as domestic corporations under section 1361), which is subject to taxation under section 11 or 1201(a), or subchapter L, chapter 1 of the Code (relating to insurance companies), if its income tax under such sections or such subchapter L for the taxable year can reasonably be expected to exceed the sum of $100,000 plus the amount of any estimated credits allowable under section 32 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds) and section 33 (relating to taxes of foreign countries and possessions of the United States).

(b) *Definition of estimated tax.* The term "estimated tax", in the case of a corporation, means the excess of the amount which such corporation estimates as its income tax liability for the taxable year under section 11 or 1201 (a), or subchapter L, chapter 1 of the Code, over the sum of $100,000 and any estimated credits under sections 32 and 33.

(c) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). C, a corporation subject to tax under section 11, reasonably anticipates that it will have taxable income of $212,500 for the calendar year 1955. The normal tax and surtax result in an expected liability of $105,000. C determines that it will not have any allowable credits under sections 32 and 33 for 1955. Since C's expected tax ($105,000) exceeds the exemption ($100,000), a declaration of estimated tax is required to be filed, reporting an estimated tax of $5,000 ($105,000–$100,000) for the calendar year 1955.

Example (2). Under the facts stated in example (1), except that C estimates it will have an allowable foreign tax credit under section 33 in the amount of $10,000, no declaration is required, since C's expected tax ($105,000) does not exceed the $100,000 exemption plus the allowable credit of $10,000.

§ 1.6016–2 Contents of declaration of estimated tax.

(a) *In general.* The declaration of estimated tax by a corporation shall be made on Form 1120–ES. For the purpose of making the declaration, the estimated tax should be based upon the amount of gross income which the taxpayer can reasonably be expected to receive or accrue as the case may be, depending upon the method of accounting upon the basis of which the taxable income is computed, and the amount of the estimated allowable deductions and credits to be taken into

account. Such amounts of gross income, deductions, and credits should be determined upon the basis of facts and circumstances existing as at the time prescribed for the filing of the declaration as well as those reasonably to be anticipated for the taxable year.

(b) *Use of prescribed form.* Copies of Form 1120–ES will so far as possible be furnished taxpayers by district directors. A taxpayer will not be excused from making a declaration, however, by the fact that no form has been furnished. Taxpayers not supplied with the proper form should make application therefor to the district director in ample time to have their declarations prepared, verified, and filed with the district director on or before the date prescribed for filing the declaration. If the prescribed form is not available a statement disclosing the estimated income tax after the exemption and the credits, if any, should be filed as a tentative declaration within the prescribed time, accompanied by the payment of the required installment. Such tentative declaration should be supplemented, without unnecessary delay, by a declaration made on the proper form.

§ 1.6016–3 Amendment of declaration.

In the making of a declaration of estimated tax the corporation is required to take into account the then existing facts and circumstances as well as those reasonably to be anticipated relating to prospective gross income, allowable deductions, and estimated credits for the taxable year. Amended or revised declarations may be made in any case in which the corporation estimates that its gross income, deductions, or credits will materially change the estimated tax reported in the previous declaration. Such amended declaration may be made on either Form 1120–ES (marked "Amended") or on the reverse side of the Notice of Final Installment furnished the corporation by the district director. See, however, paragraph (b) of § 1.6016–2 for procedure to be followed if the prescribed form is not available.

§ 1.6016–4 Short taxable year.

(a) *Requirement of declaration.* No declaration may be made for a period of more than 12 months. For purposes of this section a taxable year of 52 or 53 weeks, in the case of a corporation which computes its taxable income in accordance with the election permitted by section 441(f) shall be deemed a period of 12 months. For special rules affecting the time for filing declarations and paying estimated tax by such corporation, see paragraph (b) of § 1.441–2. A separate declaration is required where a corporation is required to submit an income tax return for a period of less than 12 months, but only if such short period ends on or after December 31, 1955. However, no declaration is required if the short taxable year is—

(1) A period of less than 9 months, or

(2) A period of 9 or more months but less than 12 months and the requirements of section 6016 (a) are not met before the 1st day of the last month in the short taxable year.

(b) *Income placed on an annual basis.* In cases where the short taxable year results from a change of annual accounting period, for the purpose of determining whether the anticipated income for a short taxable year will result in an estimated tax liability requiring the filing of a declaration, such income shall be placed on an annual basis in the manner prescribed in section 443 (b) (1). If a tax computed on such annualized income exceeds the sum of $100,000 and any credits under part IV, of subchapter A, chapter 1 of the Code, the estimated tax shall be the same part of the excess so computed as the number of months in the short period is of 12 months. Thus, for example, a corporation which changes from a calendar year basis to a fiscal year basis beginning October 1, 1956, will have a short taxable year beginning January 1, 1956, and ending September 30, 1956. If on or before August 31, 1956, the taxpayer anticipates that it will have income of $264,000 for the 9-month taxable year the estimated tax is computed as follows:

(1) Anticipated taxable income for 9 months	$264,000
(2) Annualized income ($264,000 × 12÷9)	352,000
(3) Tax liability on item (2)	177,540
(4) Item (3) reduced by $100,000 (there are no credits under part IV, subchapter A, chapter 1 of the Code)	77,540
(5) Estimated tax for 9-month period ($77,540×9÷12)	58,155

Since the tax liability on the annualized income is in excess of $100,000, a declaration is required to be filed, reporting an estimated tax of $58,155 for the 9-month taxable period. This paragraph has no application where the short taxable year does not result from a change in the taxpayer's annual accounting period.

§ 1.6017 Statutory provisions; self-employment tax returns.

SEC. 6017. *Self-employment tax returns.* Every individual (other than a nonresident alien individual) having net earnings from self-employment of $400 or more for the taxable year shall make a return with respect to the self-employment tax imposed by chapter 2. In the case of a husband and wife filing a joint return under section 6013, the tax imposed by chapter 2 shall not be computed on the aggregate income but shall be the sum of the taxes computed under such chapter on the separate self-employment income of each spouse.

§ 1.6017–1 Self-employment tax returns.

(a) *In general.* Every individual, other than a nonresident alien, having net earnings from self-employment, as defined in section 1402, of $400 or more for the taxable year shall make a return of such earnings. Except as otherwise provided in this section, such return shall be made on Form 1040 in accordance with the instructions issued with respect to such form. The form to be used by residents of the Virgin Islands is Form 1040 V.I. Residents of Puerto Rico who are required to make a return of income under section 6012(a) shall make a return of such income and earnings from self-employment on Form 1040. Residents of Puerto Rico who are not required to make a return of income under section 6012 (a) but are required to make a return of self-employment tax shall make such return on Form 1040 P.R. For purposes of this section, an individual who is a resident of the Virgin Islands or of Puerto Rico is not to be considered a nonresident alien individual. See § 1.1402 (b)–1. Provisions applicable to returns under section 6012 (a) shall be applicable to returns under this section. A return is required under this section if an individual has self-employment income, as defined in section 1402(b), even though he may not be required to make a return under section 6012 for purposes of the tax imposed by section 1 or 3.

(b) *Joint returns.* (1) In the case of a husband and wife filing a joint return under section 6013, the tax on self-employment income is computed on the separate self-employment income of each spouse, and not on the aggregate of the two amounts. The requirement of section 6013(d)(3) that in the case of a joint return the tax is computed on the aggregate income of the spouses is not applicable with respect to the tax on self-employment income. Where the husband and wife each has net earnings from self-employment of $400 or more, it will be necessary for each to complete separate schedules of the computation of self-employment tax with respect to the net earnings of each spouse, despite the fact that a joint return is filed. If the net earnings from self-employment of either the husband or the wife are less than $400, such net earnings are not subject to the tax on self-employment income, even though they must be shown on the joint return for purposes of the tax imposed by section 1 or 3.

(2) Except as otherwise expressly provided, section 6013 is applicable to the return of the tax on self-employment income; therefore, the liability with respect to such tax in the case of a joint return is joint and several.

(c) *Social security account numbers.* Every individual making a return of net earnings from self-employment is required to show thereon his social security account number, or, if he has no such account number, to make application therefor on Form SS–5 before filing such return. However, the failure to apply for or receive a social security account number will not excuse the individual from the requirement that he file such return on or before the due date thereof. Form SS–5 may be obtained from any district office of the Social Security Administration or from any district director. The application on Form SS–5 shall be filed with the district office of the Social Security Administration nearest the legal residence or principal place of business of such individual, or if he has no legal residence or principal place of business within the United States, Puerto Rico, or the Virgin Islands, with the office of the Social Security Administration at Baltimore, Maryland. An individual who has previously secured a social security account number as an employee shall use that account number on his return of net earnings from self-employment.

§ 1.6031 Statutory provisions; return of partnership income.

SEC. 6031. *Return of partnership income.* Every partnership (as defined in section 761 (a)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, and such other information for the purpose of carrying out the provisions of subtitle A as the Secretary or his delegate may by forms and regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual.

§ 1.6031–1 Return of partnership income.

(a) *In general.* Except as provided in paragraphs (b) and (d) of this section with respect to certain organizations excluded from the application of subchapter K, chapter 1 of the Code, and certain partnerships having no United States business, an unincorporated organization defined as a partnership in section 761(a), through or by means of which any business, financial operation, or venture is carried on, shall make a return for each taxable year on Form 1065. For purposes of filing a partnership return, an unincorporated organization will not be considered, within the meaning of section 761(a), to carry on a business, financial operation, or venture as a partnership before the first taxable year in which such organization receives income or makes or incurs any expenditures treated as deductions for Federal income tax purposes. Such return shall state specifically the items of partnership gross income and the deductions allowable by subtitle A of the Code and shall include the names and addresses of all the partners and the amount of the distributive shares of income, gain, loss, deduction, or credit allocated to each partner. Such return shall be made for the taxable year of the partnership, irrespective of the taxable years of the partners. For taxable years of a partnership and of a partner, see section 706 and § 1.706–1. For signing of a partnership return, see § 1.6063–1.

(b) *Unincorporated organizations excluded from the application of subchapter K*—(1) *Wholly excluded.* (i) Any unincorporated organization with respect to which under section 761(a) an election to be excluded from all the provisions of subchapter K, chapter 1 of the Code, has been made shall file Form 1065 for the first year with respect to which such an election has been made, and such return shall contain in lieu of the information therein required only the name, or other identification, and the address of the organization. See section 761 and paragraph (a)(2)(iv) of § 1.761–1.

(ii) For each subsequent taxable year or portion thereof for which it is wholly excluded from the application of subchapter K, chapter 1 of the Code, such an unincorporated organization shall file Form 1096 for the organization and Form 1099 for each person who was a member of the organization during any part of the calendar year. See section 761 and paragraph (a)(2)(v)(*a*) of § 1.761–1.

(2) *Partially excluded.* Any unincorporated organization excluded from the application of part of subchapter K, chapter 1 of the Code, shall file a return on Form 1065 containing such information as the Commissioner may require. See section 761 and paragraph (a)(2)(v)(*b*) of § 1.761–1.

(c) *Partnerships having business or source of income within the United States.* Every partnership engaged in trade or business, or having income from sources, within the United States shall file a partnership return in accordance with this section, whether or not its principal place of business is outside of the United States, and whether or not all its members are nonresident aliens.

(d) *Partnerships having no United States business*—(1) *No return required from partnership.* A partnership carrying on no business in the United States and deriving no income from sources within the United States need not file a partnership return.

(2) *Returns of information with respect to partnership required of citizen or resident partners.* Where a United States citizen or resident is a partner in a partnership described in subparagraph (1) of this paragraph which is not required to file a partnership return, the district director with whom such person files his separate return may require such person to render such statements or provide such information as is necessary to show whether or not such person is liable for tax on income derived from such partnership. In addition, if an election in accordance with the provisions of section 703 (relating to elections affecting the computation of taxable income derived from a partnership) or section 761 (relating to the election to be excluded from the application of all or part of subchapter K, chapter 1 of the Code) is to be made by or for the partnership, a return on Form 1065 shall be filed for such partnership. See section 6063 and § 1.6063–1, relating to the authority of a partner to sign a partnership return. The filing of one such return for a taxable year of the partnership by a citizen or resident partner shall constitute a filing for the partnership of such partnership return.

(e) *Place and time for filing returns*—(1) *Place for filing.* The returns of partnerships doing business, or having income from sources, within the United States shall be filed with the district director for the internal revenue district in which the partnership has its principal office or principal place of business within the United States. If a partnership has no office, place of business, or agency within the United States, the return shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C. A partnership return filed under the authority of paragraph (d)(2) of this section shall be filed with the internal revenue officer with whom the citizen or resident partner files his separate income tax return.

(2) *Time for filing.* The return of a partnership shall be filed on or before the fifteenth day of the fourth month following the close of the taxable year of the partnership, except that the return of a partnership consisting entirely of nonresident aliens shall be filed on or before the fifteenth day of the sixth month following the close of the taxable year of the partnership.

§ 1.6032 Statutory provisions; returns of banks with respect to common trust funds.

SEC. 6032. *Returns of banks with respect to common trust funds.* Every bank (as defined in section 581) maintaining a common trust fund shall make a return for each taxable year, stating specifically, with respect to such fund, the items of gross income and the deductions allowed by subtitle A, and shall include in the return the names and addresses of the participants who would be entitled to share in the taxable income if distributed and the amount of the proportionate share of each participant. The return shall be executed in the same manner as a return made by a corporation pursuant to the requirements of sections 6012 and 6062.

§ 1.6032–1 Returns of banks with respect to common trust funds.

Every bank (as defined in section 581) maintaining a common trust fund shall make a return of income of the common trust fund, regardless of the amount of its taxable income. If a bank maintains more than one common trust fund, a separate return shall be made for each. No particular form is prescribed for making the return under this section, but Form 1065 may be used if it is designated by the bank as the return of a common trust fund. The return shall be made for the taxable year of the common trust fund and shall be filed on or before the fifteenth day of the fourth month following the close of such taxable year with the district director for the district in which the income tax return of the bank is filed. Such return shall state specifically with respect to the fund the items of gross income and the deductions allowed by subtitle A of the Code, and shall include each participant's name and address, the participant's proportionate share of taxable income or net loss (exclusive of gains and losses from sales or exchanges of capital assets), and the participant's proportionate share of gains and losses from sales or exchanges of capital assets. See § 1.584–2. A copy of the plan of the common trust fund must be filed with the return. If, however, a copy of such plan has once been filed with a return, it need not again be filed if the return contains a statement showing when and where it was filed. If the plan is amended in any way after such copy has been filed, a copy of the amendment must be filed with the return for the taxable year in which the amendment was made. For the signing of a return of a bank with respect to common trust funds, see § 1.6062–1, relating to the manner prescribed for the signing of a return of a corporation.

§ 1.6033 Statutory provisions; returns by exempt organizations.

SEC. 6033. *Returns by exempt organizations*—(a) *General.* Every organization, except as hereinafter provided, exempt from taxation under section 501 (a) shall file an

annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the provisions of subtitle A as the Secretary or his delegate may by forms or regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations, as the Secretary or his delegate may from time to time prescribe, except that, in the discretion of the Secretary or his delegate, an organization described in section 401 (a) may be relieved from stating in its return any information which is reported in returns filed by the employer which established such organization. No such annual return need be filed under this subsection by any organization exempt from taxation under the provisions of section 501 (a)—

(1) Which is a religious organization described in section 501 (c) (3); or

(2) Which is an educational organization described in section 501 (c) (3), if such organization normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(3) Which is a charitable organization, or an organization for the prevention of cruelty to children or animals, described in section 501 (c) (3), if such organization is supported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or is primarily supported by contributions of the general public; or

(4) Which is an organization described in section 501 (c) (3), if such organization is operated, supervised, or controlled by or in connection with a religious organization described in paragraph (1); or

(5) Which is an organization described in section 501 (c) (8); or

(6) Which is an organization described in section 501 (c) (1), if such organization is a corporation wholly owned by the United States or any agency or instrumentality thereof, or a wholly-owned subsidiary of such a corporation.

(b) *Certain organizations described in section 501 (c) (3).* Every organization described in section 501 (c) (3) which is subject to the requirements of subsection (a) shall furnish annually information, at such time and in such manner as the Secretary or his delegate may by forms or regulations prescribe, setting forth—

(1) Its gross income for the year,

(2) Its expenses attributable to such income and incurred within the year,

(3) Its disbursements out of income within the year for the purposes for which it is exempt,

(4) Its accumulation of income within the year,

(5) Its aggregate accumulations of income at the beginning of the year,

(6) Its disbursements out of principal in the current and prior years for the purposes for which it is exempt, and

(7) A balance sheet showing its assets, liabilities, and net worth as of the beginning of such year.

(c) *Cross reference.* For provisions relating to statements, etc., regarding exempt status of organizations, see section 6001.

§ 1.6033–1 Returns by exempt organizations.

(a) *In general.* (1) Except as provided in section 6033(a) and paragraph (g) of this section, every organization exempt from taxation under section 501 (a) shall file an annual return of information specifically stating its items of gross income, receipts and disbursements, and such other information as may be prescribed in the instructions issued with respect to the return. Such information return shall be filed annually regardless of the amount or source of the income or receipts of the organization. Except as provided in paragraph (d) of this section, such return shall be filed annually regardless of whether such organization is chartered by, or affiliated or associated with, any central, parent, or other organization.

(2) Every organization exempt from taxation under section 501 (a), and required to file a return under section 6033 and this section, other than those described in sections 401 (a), 501 (c) (3), and 501 (d), shall file its annual return on Form 990.

(3) Every employees' trust described in section 401 (a) which is exempt from taxation under section 501 (a) shall file an annual return on Form 990–P. The return shall include the information required by paragraph (b) (5) (ii) of § 1.401–1. The trust must also file the information required by § 1.404 (a)–2, unless the employer has notified the trustee that he has or will timely file such information. If the trustee has received such notification from the employer, then the trust must file a copy thereof with its return and the other information required by the return.

(4) (i) Every organization described in section 501 (c) (3), which is exempt from taxation under section 501 (a), and which is required to file a return under section 6033 and this section, shall file its annual return on Form 990–A.

(ii) In addition to the information required by subparagraph (1) of this paragraph, there shall also be furnished on Form 990–A, in the manner prescribed in the instructions issued with respect to the return, the information required by section 6033 (b). See section 6104 and the regulations thereunder for publicity of information required by section 6033 (b).

(5) (i) Every religious or apostolic association or corporation described in section 501 (d) which is exempt from taxation under section 501 (a) shall file a return on Form 1065 for each taxable year, stating specifically the items of gross income and deductions, and its taxable income. There shall be attached to the return as a part thereof a statement showing the name and address of each member of the association or corporation and the amount of his distributive share of the taxable income of the association or corporation for such year.

(ii) If the taxable year of any member is different from the taxable year of the association or corporation, the distributive share of the taxable income of the association or corporation to be included in the gross income of the member for his taxable year shall be based upon the taxable income of the association or corporation for its taxable year ending with or within the taxable year of the member.

(b) *Accounting period for filing return.* A return on Form 990, Form 990–A, or Form 990–P shall be on the basis of the established annual accounting period of the organization. Where the organization has no such established accounting period, such return shall be on the basis of the calendar year.

(c) *Returns when exempt status not established.* An information return on Form 990 or Form 990–A is not required to be filed by an organization claiming an exempt status under section 501 (a) prior to the establishment by the organization of such exempt status under section 501 (a) and § 1.501 (a)–1. If the date for filing an income tax return and paying the tax occurs before the tax-exempt status of the organization has been established, the organization is required to file the return and pay the tax. However, see sections 6081 and 6161 and the regulations thereunder for extensions of time for filing the return and paying the tax. Upon establishment of its exempt status, the organization may file a claim for a refund of income taxes paid for the period for which its exempt status is established.

(d) *Group returns.* (1) A central, parent, or like organization (referred to in this paragraph as "central organization"), exempt under section 501 (a) and described in section 501 (c), although required to file a separate annual return for itself under section 6033 and paragraph (a) of this section, may file annually, in addition to such separate annual return, a group return on Form 990 or Form 990–A as may be appropriate (see paragraph (a) of this section). Such group return may be filed for two or more of the local organizations, chapters, or the like (referred to in this paragraph as "local organizations") which are (i) chartered by, or affiliated or associated with, such central organization at the close of its annual accounting period, (ii) subject to the general supervision of, and examination by, the central organization, and (iii) exempt from taxation under section 501 (a) and described by the same provision of section 501 (c) as the central organization.

(2) (i) The filing of the group return shall be in lieu of the filing of a separate return by each of the local organizations included in the group return. The group return shall include only those local organizations which in writing have authorized the central organization to include them in the group return, and which have made and filed, with the central organization, their statements, specifically stating their items of gross income, receipts, and disbursements, and such other information relating to them as is required to be stated in the group return. Such an authorization by a local organization shall be made annually, under the penalties of perjury, and shall be signed by a duly authorized officer of the local organization in his official capacity and shall contain the following statement, or a statement of like import: "I hereby declare under the penalties of perjury that this authorization (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true, correct and complete and made in good faith for the taxable year stated." Such authorizations and statements shall be permanently retained by the central organization.

(ii) There shall be attached to the group return and made a part thereof a schedule showing the name and address of each of the local organizations and the total number thereof included in such return, and a schedule showing the name and address of each of the local organizations and the total number thereof not included in the group return. Prior to or simultaneously with the filing of a group return for an accounting period ending on or after December 31, 1957, the central organization shall notify each district director for the internal revenue district in which is located the principal place of business or principal office of each local organization included in or excluded from such group return that the local organization has or has not been, or will or will not be, included in such group return. The filing with each district director concerned of a copy of each schedule described in this subdivision shall constitute notice as required by the preceding sentence.

(3) The group return shall be on the basis of the established annual accounting period of the central organization. Where such central organization has no established annual accounting period, such return shall be on the basis of the calendar year. The same income, receipts, and disbursements of a local organization shall not be included in more than one group return.

(4) The group return shall be filed in accordance with these regulations and the instructions issued with respect to Form 990 or Form 990–A, whichever is appropriate, and shall be considered the return of each local organization included therein. The tax-exempt status of a local organization must be established before a group return including the local organization will be considered as the return of the local organization. See § 1.501 (a)–1 for requirements for establishing a tax-exempt status.

(e) *Time and place for filing.* The annual return of information on Form 990, 990–A, or 990–P shall be filed on or before the fifteenth day of the fifth calendar month following the close of the period for which the return is required to be filed. The annual return on Form 1065 required to be filed by a religious or apostolic association or corporation shall be filed on or before the fifteenth day of the fourth month following the close of the taxable year for which the return is required to be filed. Each such return shall be filed with the district director for the internal revenue district in which the principal place of business or principal office of the organization is located.

(f) *Penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

(g) *Organizations not required to file annual returns.* (1) (i) Annual returns on Form 990–A are not required to be filed by an organization described in section 501 (c) (3) which has established its right to exemption from taxation under section 501 (a) and which is—

(*a*) Organized and operated exclusively for religious purposes;

(*b*) Operated, supervised, or controlled by or in connection with an organization which is organized and operated exclusively for religious purposes;

(*c*) An educational organization which normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(*d*) A charitable organization, or an organization for the prevention of cruelty to children or animals, which is suported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or which is primarily supported by contributions of the general public.

(ii) An educational organization which normally maintains and has a regular faculty, curriculum, and student body and meets the conditions of subdivision (i) (c) of this subparagraph, which relieves it from the requirement of filing annual returns, shall not be considered as having thereafter failed to continue meeting such conditions if it is temporarily compelled to curtail or discontinue its normal and regular activities during the existence of abnormal circumstances and conditions.

(iii) An organization organized and operated exclusively for charitable purposes or for the prevention of cruelty to children or animals is not "primarily supported by contributions of the general public" for any accounting period if more than 50 percent of its income and receipts for such period is not actually derived from voluntary contributions and gifts made by the general public, as distinguished from a few contributors or donors or from related or associated persons. For purposes of this subdivision, the words "related or associated persons" refer to persons of a particular group who are connected with or are interested in the activities of the organization, such as founders, incorporators, shareholders, members, fiduciaries, officers, employees, or the like, or who are connected with such persons by family or business relationships.

(2) The annual return on Form 990 need not be filed by—

(i) A fraternal beneficiary society, order, or association, described in section 501 (c) (8), or

(ii) An organization described in section 501 (c) (1) if it is a corporation wholly owned by the United States or any agency or instrumentality thereof, or is a wholly owned subsidiary of such a corporation,

which has established its exemption from tax under section 501 (a).

(3) The provisions of section 6033 (a) relieving certain specified types of organizations exempt from tax under section 501 (a) from filing annual returns do not abridge or impair in any way the powers and authority of district directors provided for in other provisions of the Code and in the regulations thereunder to require the filing of such returns by such organizations. See section 6001 and § 1.6001–1.

(h) *Records, statements, and other returns of tax-exempt organizations.* (1) An organization which has established its right to exemption from tax under section 501 (a) and has also established that it is not required to file annually the return of information on Form 990 or Form 990–A shall immediately notify in writing the district director for the internal revenue district in which its principal office is located of any changes in its character, operations, or purpose for which it was originally created.

(2) Every organization which has established its right to exemption from tax, whether or not it is required to file an annual return of information, shall submit such additional information as may be required by the district director for the purpose of enabling him to inquire further into its exempt status and to administer the provisions of subchapter F (section 501 and following), chapter 1 of the Code, and of section 6033. See section 6001 and § 1.6001–1 with respect to the authority of the district director to require such additional information and with respect to the permanent books of account or records to be kept by such organizations.

(3) An organization which has established its right to exemption from tax under section 501 (a), including an organization which is relieved under section 6033 and this section from filing annual returns of information, is not, however, relieved from the duty of filing other returns of information. See, for example, sections 6041 and 6051 and the regulations thereunder.

(i) *Unrelated business tax returns.* In addition to the foregoing requirements of this section, certain organizations otherwise exempt from tax under section 501 (a) and described in section 501 (c) (2), (3), (5), or (6) or section 401 (a) which are subject to tax on unrelated business taxable income are also required to file returns on Form 990–T. See paragraph (e) of § 1.6012–2 and paragraph (a) (5) of § 1.6012–3 for requirements with respect to such returns.

§ 1.6034 Statutory provisions; returns by trusts claiming charitable deductions under section 642(c).

SEC. 6034. *Returns by trusts claiming charitable deductions under section 642 (c)*—(a) *General rule.* Every trust claiming a charitable, etc., deduction under section 642(c) for the taxable year shall furnish such information with respect to such taxable year as the Secretary or his delegate may by forms or regulations prescribe, setting forth—

(1) The amount of the charitable, etc., deduction taken under section 642(c) within such year (showing separately the amount of such deduction which was paid out and the amount which was permanently set aside for charitable, etc., purposes during such year).

(2) The amount paid out within such year which represents amounts for which charitable, etc., deductions under section 642 (c) have been taken in prior years,

(3) The amount for which charitable, etc., deductions have been taken in prior years but which has not been paid out at the beginning of such year,

(4) The amount paid out of principal in the current and prior years for charitable, etc., purposes,

(5) The total income of the trust within such year and the expenses attributable thereto, and

(6) A balance sheet showing the assets, liabilities, and net worth of the trust as of the beginning of such year.

(b) *Exception.* This section shall not apply in the case of a taxable year if all the net income for such year, determined under the applicable principles of the law of trusts, is required to be distributed currently to the beneficiaries.

§ 1.6034–1 Information returns required of certain trusts claiming charitable or other deductions under section 642(c).

(a) *In general.* Every trust (other than a trust described in paragraph (b) of this section) claiming a charitable or other deduction under section 642(c) shall file with respect to the taxable year for which such deduction is claimed, a return of information on Form 1041–A. The return shall set forth the name and address of the trust and the following information concerning the trust in such detail as is prescribed by the form or in the instructions issued with respect to such form:

(1) The amount of the charitable or other deduction taken under section 642 (c) for the taxable year, showing separately for each class of activity for which disbursements were made (or amounts were permanently set aside) the amounts which, during such year, were paid out (or which were permanently set aside) for charitable or other purposes under section 642(c);

(2) The amount paid out during the taxable year which represents amounts permanently set aside in prior years for which charitable or other deductions have been taken under section 642(c), and separately listing for each class of activity, for which disbursements were made, the total amount paid out;

(3) The amount for which charitable or other deductions have been taken in prior years under section 642(c) and which had not been paid out at the beginning of the taxable year;

(4) (i) The amount paid out of principal in the taxable year for charitable, etc., purposes, and separately listing for each such class of activity, for which disbursements were made, the total amount paid out;

(ii) The total amount paid out of principal in prior years for charitable, etc., purposes;

(5) The gross income of the trust for the taxable year and the expenses attributable thereto, in sufficient detail to show the different categories of income and of expense; and

(6) A balance sheet showing the assets, liabilities, and net worth of the trust as of the beginning of the taxable year.

(b) *Exception.* A trust is not required to file a Form 1041–A for any taxable year with respect to which the trustee is required by the terms of the governing instrument and applicable local law to distribute currently all of the income of the trust. For this purpose, the income of the trust shall be determined in accordance with section 643(b) and §§ 1.643(b)–1 and 1.643(b)–2.

(c) *Time and place for filing return.* The return on Form 1041–A shall be filed on or before the fifteenth day of the fourth month following the close of the taxable year of the trust, with the internal revenue officer with whom the fiduciary files the return on Form 1041 for such trust.

(d) *Other provisions.* For publicity of information on Form 1041–A, see section 6104 and the regulations thereunder in Part 301 of this chapter. For the criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

§ 1.6035 Statutory provisions; returns of officers, directors, and shareholders of foreign personal holding companies.

SEC. 6035. *Returns of officers, directors, and shareholders of foreign personal holding companies*—(a) *Officers and directors*—(1) *Monthly returns.* On the 15th day of each month each individual who on such day is an officer or a director of a foreign corporation which, with respect to its taxable year preceding the taxable year in which such month occurs, was a foreign personal holding company (as defined in section 552), shall make a return setting forth with respect to the preceding calendar month the name and address of each shareholder, the class and number of shares held by each, together with any changes in stockholdings during such period, the name and address of any holder of securities convertible into stock of such corporation, and such other information with respect to the stock and securities of the corporation as the Secretary or his delegate shall by forms or regulations prescribe as necessary for carrying out the provisions of this title. The Secretary or his delegate may by regulations prescribe, as the period with respect to which returns shall be made, a longer period than a month. In such case the return shall be due on the 15th day of the succeeding period, and shall be made by the individuals who on such day are officers or directors of the corporation.

(2) *Annual returns.* On the 60th day after the close of the taxable year of a foreign personal holding company (as defined in section 552), each individual who on such 60th day is an officer or director of the corporation shall make a return setting forth—

(A) In complete detail the gross income, deductions and credits, taxable income, and undistributed foreign personal holding company income of such foreign personal holding company for such taxable year; and

(B) The same information with respect to such taxable year as is required in paragraph (1), except that if all the required returns with respect to such year have been filed under paragraph (1), no information under this subparagraph need be set forth in the return filed under this paragraph.

(b) *Shareholders*—(1) *Monthly returns.* On the 15th day of each month each United States shareholder, by or for whom 50 percent or more in value of the outstanding stock of a foreign corporation is owned directly or indirectly (including, in the case of an individual, stock owned by the members of his family as defined in section 544(a)(2)), if such foreign corporation with respect to its taxable year preceding the taxable year in which such month occurs was a foreign personal holding company (as defined in section 552), shall make a return setting forth with respect to the preceding calendar month the name and address of each shareholder, the class and number of shares held by each, together with any changes in stockholdings during such period, the name and address of any holder of securities convertible into stock of such corporation, and such other information with respect to the stock and securities of the corporation as the Secretary or his delegate shall by forms or regulations prescribe as necessary for carrying out the provisions of this title. The Secretary or his delegate may by regulations prescribe, as the period with respect to which returns shall be made, a longer period than a month. In such case the return shall be due on the 15th day of the succeeding period, and shall be made by the persons who on such day are United States shareholders.

(2) *Annual returns.* On the 60th day after the close of the taxable year of a foreign personal holding company (as defined in section 552) each United States shareholder by or for whom on such 60th day 50 percent or more in value of the outstanding stock of such company is owned directly or indirectly (including, in the case of an individual, stock owned by members of his family as defined in section 544(a)(2)) shall make a return setting forth the same information with respect to such taxable year as is required in paragraph (1), except that, if all the required returns with respect to such year have been made under paragraph (1), no return shall be required under this paragraph.

§ 1.6035–1 Returns of officers and directors of foreign personal holding companies for taxable years beginning after December 31, 1958.

(a) *Requirement of returns*—(1) *Form 957.* For taxable years beginning after December 31, 1958, on the fifteenth day of the first month after the close of each such taxable year of a foreign personal holding company (as defined in section 552), each United States citizen or resident who on such day is an officer or director of such company shall file an information return on Form 957 with respect to the stock and securities of the company setting forth the following information with respect to the taxable year:

(i) The name and address of the corporation;

(ii) The kind of business in which the corporation is engaged;

(iii) The date of incorporation;

(iv) The country under the laws of which the corporation is incorporated;

(v) The number of shares and par value of common stock of the corporation outstanding as of the beginning and end of the taxable year;

(vi) The number of shares and par value of preferred stock of the corporation outstanding as of the beginning and end of the taxable year, the rate of dividend on such stock, and whether such dividend is cumulative or noncumulative;

(vii) A description of the convertible securities issued by the corporation, including a statement of the face value of, and rate of interest on, such securities;

(viii) The name and address of each person who was a shareholder during the taxable year and the class and number of shares held by each, together with an explanation of any changes in stockholdings during the taxable year;

(ix) The name and address of each holder during the taxable year of securities convertible into stock of the corporation, and the class, number, and face value of the securities held by each, together with an explanation of any changes in the holdings of such securities during the taxable year;

(x) If any resolution or plan in respect of the dissolution of the corporation or the liquidation of the whole or any part of its capital stock was adopted during the taxable year, a certified copy of such resolution or plan and of any

amendments thereof or supplements thereto;

(xi) If the return is for any taxable year in which the corporation was organized or reorganized—

(*a*) The classes and kinds of assets transferred to the corporation for stock or securities of the corporation in connection with its formation, organization, or reorganization;

(*b*) A detailed list of any stock or securities included in the assets transferred to the corporation for stock or securities of the corporation; and

(c) The names and addresses of the persons who were the owners of assets transferred to the corporation for stock or securities of the corporation immediately prior to such transfer; and

(xii) Such other information with respect to the stock or securities of the company as may be required by the return form.

(2) *Form 958.* For taxable years beginning after December 31, 1958, on the sixtieth day after the close of the taxable year of a foreign personal holding company (as defined in section 552), each United States citizen or resident who on such day is an officer or director of such company shall file an information return on Form 958 with respect to the income of the corporation for the taxable year setting forth the following information:

(i) The gross income, deductions and credits, taxable income, foreign personal holding company income, and undistributed foreign personal holding company income for such taxable year, in complete detail;

(ii) The same information with respect to such taxable year as is required in subparagraph (1) of this paragraph, except that if all the information required under subparagraph (1) of this paragraph has been submitted, such information need not be set forth in the return on Form 958; and

(iii) Such other information as is required by the return form.

(b) *Returns jointly made.* If two or more officers or directors of a foreign personal holding company are required to file information returns for any taxable year under section 6035(a) and this section, any two or more of such officers or directors may, in lieu of filing separate returns for such year, jointly execute and file the return on Form 957 and the return on Form 958.

(c) *Separate returns for each corporation.* If a person is required to file returns under section 6035(a) and this section with respect to more than one foreign personal holding company, separate returns must be filed with respect to each company.

(d) *Place for filing returns.* Returns required under section 6035(a) and this section shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C.

(e) *Penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

§ 1.6035–2 Returns of shareholders of foreign personal holding companies for taxable years beginning after December 31, 1958.

(a) *Requirement of return.* For taxable years beginning after December 31, 1958, on the fifteenth day of the first month after the close of each such taxable year of a foreign personal holding company (as defined in section 552) each United States shareholder, by or for whom on such day 50 percent or more in value of the outstanding stock of such company is owned directly or indirectly, shall file an information return on Form 957 for such taxable year. For purposes of this section, an individual shall be considered as owning the stock owned by members of his family, as described in section 544(a)(2). The return shall set forth for the taxable year the same information as is required under paragraph (a)(1) of § 1.6035–1.

(b) *Duplicate returns.* If a shareholder of a foreign personal holding company is required to file a return as an officer or a director of such company under section 6035(a) and paragraph (a)(1) of § 1.6035–1, he shall file such return and not the return required to be filed under section 6035(b) and this section.

(c) *Separate return for each corporation.* If a person is required to file a return under section 6035(b) and this section with respect to more than one foreign personal holding company, a separate return must be filed with respect to each company.

(d) *Place for filing return.* The return required under section 6035(b) and this section shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C.

(e) *Penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

§ 1.6035–3 Returns of officers, directors, and shareholders of foreign personal holding companies for periods within or for taxable years beginning before January 1, 1959.

(a) For rules relating to information returns required to be filed by officers and directors of foreign personal holding companies for periods within or for taxable years beginning before January 1, 1959, see 26 CFR (1939) 39.338–1 and 39.338–2 (Regulations 118) as made applicable under the Internal Revenue Code of 1954 by Treasury Decision 6091, approved August 16, 1954 (19 F.R. 5167, C.B. 1954–2, 47).

(b) For rules relating to information returns required to be filed by shareholders of foreign personal holding companies for taxable years beginning before January 1, 1959, see 26 CFR (1939) 39.339–1 and 39.339–2 (Regulations 118) as made applicable under the Internal Revenue Code of 1954 by Treasury Decision 6091, approved August 16, 1954 (19 F.R. 5167, C.B. 1954–2, 47).

§ 1.6036 Statutory provisions; notice of qualification as executor or receiver.

SEC. 6036. *Notice of qualification as executor or receiver.* Every receiver, trustee in bankruptcy, assignee for benefit of creditors, or other like fiduciary, and every executor (as defined in section 2203), shall give notice of his qualification as such to the Secretary or his delegate in such manner and at such time as may be required by regulations of the Secretary or his delegate. The Secretary or his delegate may by regulation provide such exemptions from the requirements of this section as the Secretary or his delegate deems proper.

§ 1.6036–1 Notice of qualification as executor or receiver.

For provisions relating to the notice required of fiduciaries, see the regulations under section 6036 contained in Part 301 of this chapter (Regulations on Procedure and Administration).

§ 1.6037 Statutory provisions; return of electing small business corporation.

SEC. 6037. *Return of electing small business corporation.* Every electing small business corporation (as defined in section 1371 (a)(2)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, the names and addresses of all persons owning stock in the corporation at any time during the taxable year, the number of shares of stock owned by each shareholder at all times during the taxable year, the amount of money and other property distributed by the corporation during the taxable year to each shareholder, the date of each such distribution, and such other information, for the purpose of carrying out the provisions of subchapter S of chapter 1, as the Secretary or his delegate may by forms and regulations prescribe. Any return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012.

[Sec. 6037 as added by sec. 64(c), Technical Amendments Act 1958 (72 Stat. 1656)]

§ 1.6037–1 Return of electing small business corporation.

(a) *In general.* Every small business corporation (as defined in section 1371 (a)) which has made an election under section 1372(a) not to be subject to the tax imposed by chapter 1 of the Code shall file, with respect to each taxable year for which the election is in effect, a return of income on Form 1120–S. The return shall set forth the items of gross income and the deductions allowable in computing taxable income as required by the return form or in the instructions issued with respect thereto and shall be signed in accordance with section 6062 by the person authorized to sign a return. The return shall also set forth the following information concerning the electing small business corporation:

(1) The names and addresses of all persons owning stock in the corporation at any time during the taxable year;

(2) The number of shares of stock owned by each shareholder at all times during the taxable year;

(3) The amount of money and other property distributed by the corporation during the taxable year to each shareholder;

(4) The date of each distribution of money and other property; and

(5) Such other information as is required by the form or by the instructions issued with respect to such form.

(b) *Time and place for filing return.* The return shall be filed on or before the 15th day of the third month following

the close of the taxable year with the district director for the internal revenue district in which the corporation's principal place of business or principal office or agency is located. (See section 6072.)

(c) *Other provisions.* The return on Form 1120–S will be treated as a return filed by the corporation under section 6012, relating to persons required to make returns of income, for purposes of the provisions of chapter 66 of the Code, relating to limitations. Thus, for example, the period of limitation on assessment and collection of any corporate tax found to be due upon a subsequent determination that the corporation was not entitled to the benefits of subchapter S, chapter 1 of the Code, will run from the date of filing the return under section 6037, or from the date prescribed for filing such return, whichever is the later.

(d) *Penalties.* For criminal penalties for failure to file a return, supply information, or pay tax, and for filing a false or fraudulent return, statement, or other document, see sections 7203, 7206, and 7207.

§ 1.6041 Statutory provisions; information at source.

SEC. 6041. *Information at source*—(a) *Payments of $600 or more.* All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in section 6042(1) or section 6045), of $600 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Secretary or his delegate, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary or his delegate, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

(b) *Collection of foreign items.* In the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by any person undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange, such person shall make a return according to the forms or regulations prescribed by the Secretary or his delegate, setting forth the amount paid and the name and address of the recipient of each such payment.

(c) *Payments of interest by corporations.* Every corporation making payments of interest, regardless of amounts, shall, when required by regulations of the Secretary or his delegate, make a return according to the forms or regulations prescribed by the Secretary or his delegate, setting forth the amount paid and the name and address of the recipient of each such payment.

(d) *Recipient to furnish name and address.* When necessary to make effective the provisions of this section, the name and address of the recipient of income shall be furnished upon demand of the person paying the income.

§ 1.6041–1 Return of information as to payments of $600 or more.

(a) *General rule.* (1) Except as provided in § 1.6041–3, every person engaged in a trade or business shall make an information return for the calendar year with respect to payments made by him during such year in the course of his trade or business to another person of fixed or determinable—

(i) Salaries, wages, commissions, fees, and other forms of compensation for services rendered aggregating $600 or more;

(ii) Interest, rents, royalties, annuities, pensions, and other gains, profits, and income aggregating $600 or more; or

(iii) Foreign items, as defined in § 1.6041–4, aggregating $600 or more.

The payments described in subdivisions (i), (ii), and (iii) of this subparagraph shall not include any payments described in sections 6042(1), 6043(2), 6044, and 6045.

(2) The return required by this paragraph shall be made on Forms 1099 and 1096, except that the return with respect to distributions to beneficiaries of a trust or of an estate shall be made on Form 1041. A separate Form 1099 shall be furnished for each person to whom such payments of $600 or more are made. For time and place for filing Forms 1099 and 1096, see § 1.6041–6.

(b) *Persons engaged in trade or business.* The term "all persons engaged in a trade or business", as used in section 6041(a), includes not only those so engaged for gain or profit, but also organizations the activities of which are not for the purpose of gain or profit. Thus, the term includes the organizations referred to in section 401(a), 501(c), 501(d) and 521 and in paragraph (g) of this section. On the other hand, section 6041(a) applies only to payments in the course of trade or business; hence it does not apply to an amount paid by the proprietor of a business to a physician for medical services rendered by the physician to the proprietor's child.

(c) *Fixed or determinable income.* Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually or at regular intervals. The fact that the payments may be increased or decreased in accordance with the happening of an event does not for purposes of this section make the payments any the less determinable. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable income.

(d) *Payments specifically included.* (1) Sums paid in respect of life insurance, endowment, or annuity contracts are required to be reported in returns of information—

(i) Unless the payment is made in respect of a life insurance or endowment contract by reason of the death of the insured and is not required to be reported by paragraph (b) of § 1.6041–2, or

(ii) Unless the payment is made by reason of the surrender or lapse of a policy which the insurance company can establish by its records was purchased and paid for by the insured.

(2) Fees for professional services paid to attorneys, physicians, and members of other professions are required to be reported in returns of information if paid by persons engaged in a trade or business and paid in the course of such trade or business.

(3) Amounts paid as prizes and awards which are required to be included in gross income under section 74 and § 1.74–1 when paid in the course of a trade or business shall be reported in returns of information.

(e) *Payment made in medium other than cash.* If any payment required to be reported on Form 1099 is made in property other than money, the fair market value of the property at the time of payment is the amount to be included on such form.

(f) *When payment deemed made.* For purposes of a return of information, an amount is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

(g) *Payments made by United States, State, or Territory.* Returns on Forms 1099 and 1096 of payments made by the United States, or a State, Territory, or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing, shall be made by the officer or employee of the United States, or of such State, Territory, or political subdivision, or of the District of Columbia, or of such agency or instrumentality, as the case may be, having control of such payments or by the officer or employee appropriately designated to make such returns.

§ 1.6041–2 Return of information as to payments to employees.

(a) *In general.* Wages, as defined in section 3401, paid to an employee are required to be reported on Form W–2. All other payments of compensation, including the cash value of payments made in any medium other than cash, to an employee by his employer in the course of the trade or business of the employer must be reported on Form 1099 if the total of such payments and the amount of the employee's wages, if any, required to be reported on Form W–2 equals $600 or more in a calendar year. For example, if a payment of $700 was made to an employee and $400 thereof represents wages subject to withholding under section 3402 and the remaining $300 represents compensation not subject to withholding, the $400 must be reported on Form W–2 and the $300 must be reported on Form 1099.

(b) *Distribution under employees' trust.* Amounts which are distributed or made available to a beneficiary, and to which section 402 (relating to employees' trusts) or section 403 (relating to employee annuity plans) applies, shall be

reported on Forms 1099 and 1096 to the extent such amounts are includible in the gross income of such beneficiary when the amounts so includible are $600 or more in any calendar year.

§ 1.6041–3 Payments for which no return of information on Forms 1099 and 1096 is required.

Payments of the following character need not be reported on Forms 1099 and 1096—

(a) Payments of income required to be reported on Forms 1012, 1013, 1042, 1042S, 1000, 1001 (including all special variations thereof), 941, W–2, and W–3;

(b) Payments by a broker to his customer;

(c) Payments of any type made to corporations (except payments described in section 6044 and § 1.6044–1);

(d) Payments of bills for merchandise, telegrams, telephone, freight, storage, and similar charges;

(e) Payments of rent made to real estate agents (but the agent is subject to the requirements of paragraph (a)(1)(ii) of § 1.6041–1);

(f) Payments representing earned income for services rendered without the United States made to a citizen of the United States, if it is reasonable to believe that such amounts will be excluded from gross income under the provisions of section 911 and the regulations thereunder;

(g) Salaries and profits paid or distributed by a partnership to the individual partners;

(h) Payments of commissions to general agents by fire insurance companies or other companies insuring property, except when specifically directed by the Commissioner to be filed;

(i) Advances, reimbursements, or charges for traveling and other business expenses of an employee to the extent that the employee is required to account (within the meaning of the term "account" as set forth in paragraph (b)(4) of § 1.162–17) and does so account to his employer for such expenses;

(j) Amounts paid to persons in the military or civil service of the United States or a State, Territory or political subdivision thereof, or the District of Columbia as an allowance or reimbursement for traveling or other bona fide ordinary and necessary expenses, including an allowance for meals and lodging or a per diem allowance in lieu of subsistence;

(k) Payments of interest on obligations of the United States, or a State, Territory, or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing (but for requirements for reporting certain such payments by the United States or any agency or instrumentality thereof, see §§ 1.1461–1 to 1.1461–3, inclusive);

(l) Payments of interest on corporate bonds (but for requirements for reporting payments of interest on bonds, mortgages, deeds of trust, or other similar obligations issued before January 1, 1934, and containing a tax-free covenant, see §§ 1.1461–1 to 1.1461–3, inclusive);

(m) Payments made to employees for services performed in Puerto Rico;

(n) Amounts paid to persons in the service of an international organization, as defined in section 7701(a)(18), as an allowance or reimbursement for traveling or other bona fide ordinary and necessary expenses, including an allowance for meals and lodging or a per diem allowance in lieu of subsistence; and

(o) A payment of a type determined by the Commissioner to be paid as an award to an informer or other payment of a similar character made by the United States, a State, Territory, or political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing.

§ 1.6041–4 Returns of information as to foreign items.

(a) *In general.* If the amount of foreign items, as defined in paragraph (b) of this section, paid in any calendar year to a citizen or resident of the United States (individual or fiduciary), or a partnership any member of which is a citizen or resident of the United States, is $600 or more, an information return on Form 1099 setting forth the amount of such items is required to be filed by any person who accepts the item for collection as a matter of business or for profit, such as a bank. As used in this section, the term "collection" includes (1) payment of the foreign item in cash; (2) the crediting of the account of the person presenting the foreign item; (3) the tentative crediting of the account of the person presenting the foreign item until the amount of the foreign item is received by the bank or collecting agent from abroad; and (4) the receipt of foreign items for the purpose of transmitting them abroad for deposits.

(b) *Foreign items defined.* The term "foreign items", as used in this section, means any item of interest upon the bonds of a foreign country or of a nonresident foreign corporation not having a fiscal or paying agent in the United States (including Puerto Rico as if a part of the United States), or any item of dividends upon the stock of such corporation.

(c) *License to collect foreign items.* A bank or agent collecting foreign items is required to obtain a license pursuant to the provisions of section 7001 and the regulations thereunder in Part 301 of this chapter (Regulations on Procedure and Administration).

§ 1.6041–5 Information as to actual owner.

When a person receiving a payment described in section 6041 is not the actual owner of the income received, the name and address of the actual owner shall be furnished upon demand of the person paying the income, and in default of compliance with such demand the payee becomes liable for the penalties provided. See section 7203.

§ 1.6041–6 Time and place for filing Forms 1099 and 1096 and information to be shown on Form 1099.

Forms 1099 and 1096 for any calendar year shall be filed on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms. The name and address of the person making the payment and the name and address of the recipient of the payment shall be stated on Form 1099. If the present address of the recipient is not available, the last known post office address must be given.

§ 1.6042 Statutory provisions; returns regarding corporate dividends, earnings, and profits.

SEC. 6042. *Returns regarding corporate dividends, earnings, and profits.* Every corporation shall, when required by the Secretary or his delegate—

(1) Make a return of its payments of dividends, stating the name and address of, the number of shares owned by, and the amount of dividends paid to, each shareholder;

(2) Furnish to the Secretary or his delegate a statement of such facts as will enable him to determine the portion of the earnings or profits of the corporation (including gains, profits, and income not taxed) accumulated during such periods as the Secretary or his delegate may specify, which have been distributed or ordered to be distributed, respectively, to its shareholders during such taxable years as the Secretary or his delegate may specify; and

(3) Furnish to the Secretary or his delegate a statement of its accumulated earnings and profits and the names and addresses of the individuals or shareholders who would be entitled to such accumulated earnings and profits if divided or distributed, and of the amounts that would be payable to each.

§ 1.6042–1 Return of information as to payments of dividends.

(a) *Requirement of return*—(1) *In general.* Except as provided in subparagraphs (2) and (3) of this paragraph, every domestic corporation, or foreign corporation engaged in business within the United States or having an office or place of business or a fiscal or paying agent in the United States, making payments during the calendar year of $10 or more of dividends and distributions (other than distributions in liquidation) to any shareholder who is an individual (citizen or resident of the United States), a resident fiduciary, or a resident partnership any member of which is a citizen or resident shall file for the calendar year a return setting for the amount of such payments for such calendar year. A separate return on Form 1099, showing the name and address of the payor and the shareholder, and the amount paid, shall be prepared with respect to each shareholder. These returns shall be accompanied by transmittal Form 1096.

(2) *Federal land bank associations and certain other corporations.* A corporation described in section 501(c)(12), (15), or (16), or section 521(b)(1), or a Federal land bank association or a production credit association, making a payment of a dividend or a distribution to any shareholder shall file an information return with respect to such payments when they total $100 or more during the calendar year.

(3) *Savings and loan associations, etc.* A savings and loan association, a

cooperative bank, a homestead association, a credit union, or a building and loan association is required to file an information return with respect to distributions to a shareholder only if the amount thereof paid to the shareholder during the calendar year, or such amount when aggregated with other payments made to the shareholder during such year of interest, rents, royalties, annuities, pensions, and other gains, profits, and income, as described in paragraph (a)(1)(ii) of § 1.6041–1, totals $600 or more. For this purpose, the term "distributions to a shareholder" includes periodical distributions of earnings on running installment shares of stock paid or credited by a building and loan association to its holders of that class of stock, and the sum received upon withdrawal from a building and loan association in excess of the amounts paid in on account of membership fees and stock subscriptions, consisting of accumulated profits.

(b) *Nontaxable or partly nontaxable distributions.* In the case of a distribution which is made from a depletion or depreciation reserve, or which for any other reason is deemed by the corporation to be nontaxable or partly nontaxable to its shareholders, the corporation shall fill in the information on both sides of Form 1096.

(c) *Information as to actual owner*—(1) *In general.* When the person receiving a payment with respect to which an information return is required under authority of the Internal Revenue Code of 1954 is not the actual owner of the income received, the name and address of the actual owner or payee shall be furnished upon demand of the person paying the income, and in default of a compliance with such demand the payee becomes liable for the penalties provided. See section 7203. Dividends on stock are prima facie the income of the record owner of the stock. If a record owner of stock who is not the actual owner thereof receives dividends on such stock, he shall file a Form 1087 disclosing the name and address of the actual owner or payee, the name of the issuing corporation, the number of shares of such stock, and the amount of dividends received with respect to such stock during the calendar year. Unless such a disclosure is made the record owner will be held liable for any tax based upon such dividends. A separate Form 1087 shall be filed by the record owner for each of the stockholdings of each actual owner for whom he acts as nominee. However, where the record owner is a banking institution, trust company, or brokerage firm, it may, provided it maintains such records as will permit a prompt substantiation of each payment of dividends made to the actual owner, file one Form 1087 for each actual owner for whom it acts as nominee and report thereon the total amount of the dividends paid to such actual owner (without itemization as to the issuing company, class of stock, etc.).

(2) *Exceptions.* The filing of Form 1087 is not required if—

(i) The record owner is required to file a fiduciary return on Form 1041, or a withholding return on Form 1042, disclosing the name and address of the actual owner or payee;

(ii) The actual owner or payee is a nonresident alien individual, foreign partnership, or foreign corporation and the tax has been withheld at the source before receipt of the dividends by the record owner;

(iii) The record owner is a banking institution, a trust company, or a brokerage firm which prepares the individual income tax return of the actual owner, provided the verification on the return with respect to the preparation thereof is executed by such record owner;

(iv) The record owner is a nominee of a banking institution or trust company exercising trust powers, and such banking institution or trust company is required to file a fiduciary return on Form 1041 which reflects the name and address of the actual owner or payee;

(v) The actual owner is an organization exempt from taxation under section 501(a) and is exempt from the requirement of filing a return under section 6033 and paragraph (g) of § 1.6033–1; or

(vi) The record owner is a banking institution or trust company exercising trust powers, or a nominee thereof, and the actual owner is an organization exempt from taxation under section 501(a) for which such banking institution or trust company files an annual return.

See § 1.1441–1, relating to withholding of tax on nonresident alien individuals, and § 1.1442–1, relating to withholding of tax on nonresident foreign corporations.

(d) *Time and place for filing.* Forms 1099, 1096, and 1087 for any calendar year shall be filed on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms.

§ 1.6043 Statutory provisions; return regarding corporate dissolution or liquidation.

SEC. 6043. *Return regarding corporate dissolution or liquidation.* Every corporation shall—

(1) Within 30 days after the adoption by the corporation of a resolution or plan for the dissolution of the corporation or for the liquidation of the whole or any part of its capital stock, make a return setting forth the terms of such resolution or plan and such other information as the Secretary or his delegate shall by forms or regulations prescribe; and

(2) When required by the Secretary or his delegate, make a return regarding its distributions in liquidation, stating the name and address of, the number and class of shares owned by, and the amount paid to, each shareholder, or, if the distribution is in property other than money, the fair market value (as of the date the distribution is made) of the property distributed to each shareholder.

§ 1.6043–1 Return regarding corporate dissolution or liquidation.

(a) *Requirement of returns.* Within 30 days after the adoption of any resolution or plan for or in respect of the dissolution of a corporation or the liquidation of the whole or any part of its capital stock, the corporation shall file a return on Form 966, containing the information required by paragraph (b) of this section and by such form. Such return shall be filed with the district director for the district in which the income tax return of the corporation is filed. Further, if after the filing of a Form 966 there is an amendment of or supplement to the resolution or plan, an additional Form 966, based on the resolution or plan as amended or supplemented, must be filed within 30 days after the adoption of such amendment or supplement. A return must be filed under section 6043 and this section in respect of a liquidation whether or not any part of the gain or loss to the shareholders upon the liquidation is recognized under the provisions of section 1002.

(b) *Contents of return*—(1) *In general.* There shall be attached to and made a part of the return required by section 6043 and paragraph (a) of this section a certified copy of the resolution or plan, together with any amendments thereof or supplements thereto, and such return shall in addition contain the following information:

(i) The name and address of the corporation;

(ii) The place and date of incorporation;

(iii) The date of the adoption of the resolution or plan and the dates of any amendments thereof or supplements thereto; and

(iv) The internal revenue district in which the last income tax return of the corporation was filed and the taxable year covered thereby.

(2) *Liquidation within one calendar month.* If the corporation is a domestic corporation, and the plan of liquidation provides for a distribution in complete cancellation or redemption of all the capital stock of the corporation, and for the transfer of all the property of the corporation under the liquidation entirely within some one calendar month pursuant to section 333, and any shareholder claims the benefit of such section, such return shall, in addition to the information required by subparagraph (1) of this paragraph, contain the following:

(i) A statement showing the number of shares of each class of stock outstanding at the time of the adoption of the plan of liquidation, together with a description of the voting power of each such class;

(ii) A list of all the shareholders owning stock at the time of the adoption of the plan of liquidation, together with the number of shares of each class of stock owned by each shareholder, the certificate numbers thereof, and the total number of votes to which entitled on the adoption of the plan of liquidation; and

(iii) A list of all corporate shareholders as of January 1, 1954, together with the number of shares of each class of stock owned by each such shareholder, the certificate numbers thereof, the total number of votes to which entitled on the adoption of the plan of liquidation, and a statement of all changes in ownership of stock by corporate shareholders between January 1, 1954, and the date of the adoption of the plan of liquidation, both dates inclusive.

(3) *Returns in respect of amendments or supplements.* If a return has been

filed pursuant to section 6043 and this section, any additional return made necessary by an amendment of or a supplement to the resolution or plan will be deemed sufficient if it gives the date the prior return was filed and contains a duly certified copy of the amendment or supplement and all other information required by this section and by Form 966 which was not given in the prior return.

§ 1.6043–2 Return of information respecting distributions in liquidation.

(a) Unless the distribution is one in respect of which information is required to be filed pursuant to paragraph (b) of § 1.332–6, paragraph (a) of § 1.368–3, or § 1.1081–11, every corporation making any distribution of $600 or more during a calendar year to any shareholder in liquidation of the whole or any part of its capital stock shall file a return of information on Forms 1096 and 1099L, giving all the information required by such forms and by the regulations in this part. A separate Form 1099L must be prepared for each shareholder to whom such distribution was made, showing the name and address of such shareholder, the number and class of shares owned by him in liquidation of which such distribution was made, and the total amount distributed to him on each class of stock. If the amount distributed to such shareholder on any class of stock consisted in whole or in part of property other than money, the return on such form shall in addition show the amount of money distributed, if any, and shall list separately each class of property other than money distributed, giving a description of the property in each such class and a statement of its fair market value at the time of the distribution. Such forms, accompanied by transmittal Form 1096 showing the number of Forms 1099L filed therewith, shall be filed on or before February 28 of the year following the calendar year in which such distribution was made with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms.

(b) If the distribution is in complete liquidation of a domestic corporation pursuant to a plan of liquidation in accordance with which all the capital stock of the corporation is canceled or redeemed, and the transfer of all the property under the liquidation occurs within some one calendar month pursuant to section 333, and any shareholder claims the benefit of such section, the return on Form 1096 shall show (1) the amount of earnings and profits of the corporation accumulated after February 28, 1913, determined as of the close of such calendar month, without diminution by reason of distribution made during such calendar month, but including in such computation all items of income and expense accrued up to the date on which the transfer of all the property under the liquidation is completed, (2) the ratable share of such earnings and profits of each share of stock canceled or redeemed in the liquidation, and (3) the date and circumstances of the acquisition by the corporation of any stock or securities distributed to shareholders in the liquidation.

§ 1.6044 Statutory provisions; returns regarding patronage dividends.

SEC. 6044. *Returns regarding patronage dividends*—(a) *Payments of $100 or more.* Any corporation allocating amounts as patronage dividends, rebates, or refunds (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, refund, or rebate) shall make a return showing—

(1) The name and address of each patron to whom it has made such allocations amounting to $100 or more during the calendar year; and

(2) The amount of such allocations to each patron.

(b) *Payments regardless of amount.* If required by the Secretary or his delegate, any such corporation shall make a return of all patronage dividends, rebates, or refunds made during the calendar year to its patrons.

(c) *Exceptions.* This section shall not apply in the case of any corporation (including any cooperative or nonprofit corporation engaged in rural electrification) described in section 501(c) (12) or (15) which is exempt from tax under section 501(a), or in the case of any corporation subject to a tax imposed by subchapter L of chaper 1.

§ 1.6044–1 Returns of information as to patronage dividends, rebates, or refunds.

(a) *Requirement*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, any corporation allocating to any patron amounts aggregating $100 or more during the calendar year as patronage dividends, rebates, or refunds (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, rebate, or refund) shall for each calendar year file a return of information with respect to such allocation on Forms 1096 and 1099. A separate Form 1099 shall be prepared for each patron showing the name and address of the patron to whom such allocation is made, and the amount of the allocation. The allocation shall be reported for the calendar year during which the allocation is made, regardless of whether the allocation is deemed for the purpose of section 522 to be made at the close of a preceding taxable year of the corporation.

(2) *Exception.* A return under section 6044 and this section is not required in the case of any corporation (including any cooperative or nonprofit corporation engaged in rural electrification) described in section 501(c) (12) or (15) which is exempt from tax under section 501(a), or in the case of any corporation subject to a tax imposed by subchapter L, chapter 1 of the Code.

(b) *Time and place for filing returns.* Forms 1099, accompanied by transmittal Form 1096, shall be filed on or before February 28 of the following year with any of the Internal Revenue Service Centers, the addresses of which are listed in the instructions for such forms.

(c) *Definitions.* The terms "cooperative association", "patron", "patronage dividends, rebates, and refunds", and "allocation" are defined, for the purpose of this section, in paragraph (b) of § 1.522–1.

§ 1.6045 Statutory provisions; returns of brokers.

SEC. 6045. *Returns of brokers.* Every person doing business as a broker shall, when required by the Secretary or his delegate, make a return, in accordance with such regulations as the Secretary or his delegate may prescribe, showing the names of customers for whom such person has transacted any business, with such details regarding the profits and losses and such other information as the Secretary or his delegate may by forms or regulations require with respect to each customer as will enable the Secretary or his delegate to determine the amount of such profits or losses.

§ 1.6046 Statutory provisions; returns as to formation or reorganization of foreign corporations.

SEC. 6046. *Returns as to formation or reorganization of foreign corporations*—(a) *Requirement.* Every attorney, accountant, fiduciary, bank, trust company, financial institution, or other person, who aids, assists, counsels, or advises in, or with respect to, the formation, organization, or reorganization of any foreign corporation, shall, within 30 days thereafter, make a return in accordance with regulations prescribed by the Secretary or his delegate.

(b) *Form and contents of return.* Such return shall be in such form, and shall set forth, in respect of each such corporation, to the full extent of the information within the possession or knowledge or under the control of the person required to make the return, such information as the Secretary or his delegate prescribes by forms or regulations as necessary for carrying out the provisions of the income tax laws.

(c) *Privileged communications.* Nothing in this section shall be construed to require the making of a return by an attorney-at-law with respect to any advice given or information obtained through the relationship of attorney and client.

(d) *Cross reference.* For. provisions relating to penalties for violations of this section, see section 7203.

§ 1.6046–1 Returns as to formation or reorganization of foreign corporations.

(a) *Requirement of returns.* Every attorney, accountant, fiduciary, bank, trust company, financial institution, or other person, who aids, assists, counsels, or advises in, or with respect to, the formation, organization, or reorganization of any foreign corporation shall file an information return on Form 959. The return must be filed in every such case regardless of—

(1) The nature of the counsel or advice given, whether for or against the formation, organization, or reorganization of the foreign corporation, or the nature of the aid or assistance rendered, and

(2) The action taken upon the advice or counsel, that is, whether the foreign corporation is actually formed, organized or reorganized.

(b) *Special provisions*—(1) *Employers.* In the case of aid, assistance, counsel, or advice in, or with respect to, the formation, organization, or reorganization of a foreign corporation given by a person in whole or in part through the medium of employees (including, in the

case of a corporation, the officers thereof), the return made by the employer must set forth in detail the information required by this section including that which, as an incident to such employment, is within the possession or knowledge or under the control of such employees.

(2) *Employees.* The obligation of an employee (including, in the case of a corporation, the officers thereof) to file a return with respect to any aid, assistance, counsel, or advice in or with respect to the formation, organization, or reorganization of a foreign corporation, given as an incident to his employment, will be satisfied if a return as prescribed by this section is duly filed by the employer. Clerks, stenographers, and other employees rendering aid or assistance solely of a clerical or mechanical character in or with respect to the formation, organization, or reorganization of a foreign corporation are not required to file returns by reason of such services.

(3) *Partners.* In the case of aid, assistance, counsel, or advice in, or with respect to, the formation, organization, or reorganization of a foreign corporation given by one or more members of a partnership in the course of its business, the obligation of each such individual member to file a return will be satisfied if a return as prescribed by this section is duly filed by the partnership executed by all the members of the firm who gave any such aid, assistance, counsel, or advice. If, however, the partnership has been dissolved at the time the return is due, individual returns must be filed by each member of the former partnership who gave any such aid, assistance, counsel, or advice.

(4) *Return jointly made.* If two or more persons aid, assist, counsel, or advise in, or with respect to, the formation, organization, or reorganization of a particular foreign corporation, any two or more of such persons may, in lieu of filing several returns, jointly execute and file one return.

(5) *Separate return for each corporation.* If a person aids, assists, counsels, or advises in, or with respect to, the formation, organization, or reorganization of more than one foreign corporation, a separate return must be filed with respect to each foreign corporation.

(c) *Information required to be shown on return.* The return required by section 6046 and this section shall set forth the following information to the extent the information is within the possession or knowledge, or under the control, of the person filing the return:

(1) The name and address of the person (or persons) to whom, and the person (or persons) for whom, or on whose behalf, the aid, assistance, counsel, or advice was given;

(2) The name and address of the foreign corporation and the country under the laws of which it was formed, organized, or reorganized;

(3) The month and year when the foreign corporation was formed, organized, or reorganized;

(4) A statement of the manner in which the formation, organization, or reorganization of the foreign corporation was effected;

(5) A complete statement of the reasons for, and the purposes sought to be accomplished by, the formation, organization, or reorganization of the foreign corporation;

(6) A statement showing the classes and kinds of assets transferred to the foreign corporation in connection with its formation, organization, or reorganization, including a detailed list of any stock or securities included in such assets, and a statement showing the names and addresses of the persons who were the owners of such assets immediately prior to the transfer;

(7) The names and addresses of the shareholders of the foreign corporation at the time of the completion of its formation, organization, or reorganization, showing the classes of stock and number of shares held by each and, in the case of Forms 959 filed after December 31, 1958, the names and addresses of the subscribers to the stock of the foreign corporation and the number of shares subscribed to by each;

(8) The name and address of the person (or persons) having custody of the books of account and records of the foreign corporation; and

(9) Such other information as is required by the return form.

(d) *Privileged communications.* An attorney-at-law is not required to file a return with respect to any advice given or information obtained through the relationship of attorney and client.

(e) *Time and place for filing return—*(1) *Time for filing.* Returns required by section 6046 and this section shall be filed within 30 days after the first performance of any of the functions referred to in paragraph (a) of this section. If, in a particular case, the aid, assistance, counsel, or advice given by any person extends over a period of more than one day, such person, to avoid the multiple filing of returns, shall file a return within 30 days after either of the following events:

(i) The formation, organization, or reorganization of the foreign corporation, or

(ii) The termination of his aid, assistance, counsel, or advice in, or with respect to, the formation, organization, or reorganization of the foreign corporation.

(2) *Place for filing.* Returns required by section 6046 and this section shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C.

(f) *Penalties.* For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

SIGNING AND VERIFYING OF RETURNS AND OTHER DOCUMENTS

§ 1.6061 Statutory provisions; signing of returns and other documents.

SEC. 6061. *Signing of returns and other documents.* Except as otherwise provided by sections 6062 and 6063, any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall be signed in accordance with forms or regulations prescribed by the Secretary or his delegate.

§ 1.6061–1 Signing of returns and other documents by individuals.

(a) *Requirement.* Each individual (including a fiduciary) shall sign the income tax return required to be made by him, except that the return may be signed for the taxpayer by an agent who is duly authorized in accordance with paragraph (a)(5) of § 1.6012–1 to make such return. Other returns, statements, or documents required under the provisions of subtitle A or F of the Code or of the regulations thereunder to be made by any person with respect to any tax imposed by subtitle A of the Code shall be signed in accordance with any regulations contained in this chapter, or any instructions, issued with respect to such returns, statements, or other documents.

(b) *Cross references.* For provisions relating to the signing of returns, statements, or other documents required to be made by corporations and partnerships with respect to any tax imposed by subtitle A of the Code, see §§ 1.6062–1 and 1.6063–1, respectively. For provisions relating to the making of returns by agents, see paragraphs (a)(5) and (b)(6) of § 1.6012–1; and to the making of returns for minors and persons under a disability, see paragraph (a)(4) of § 1.6012–1 and paragraph (b) of § 1.6012–3.

§ 1.6062 Statutory provisions; signing of corporation returns.

SEC. 6062. *Signing of corporation returns.* The return of a corporation with respect to income shall be signed by the president, vice-president, treasurer, assistant treasurer, chief accounting officer or any other officer duly authorized so to act. In the case of a return made for a corporation by a fiduciary pursuant to the provisions of section 6012(b)(3), such fiduciary shall sign the return. The fact that an individual's name is signed on the return shall be prima facie evidence that such individual is authorized to sign the return on behalf of the corporation.

§ 1.6062–1 Signing of returns, statements, and other documents made by corporations.

(a) *Returns*—(1) *In general.* Returns required to be made by corporations under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A of the Code, shall be signed for the corporation by the president, vice-president, treasurer, assistant treasurer, chief accounting officer, or any other officer duly authorized to sign such returns. It is not necessary that the corporate seal be affixed to the return. Spaces provided on return forms for affixing the corporate seal are for the convenience of corporations required by charter, or by the law of the jurisdiction in which they are incorporated, to affix their corporate seals in the execution of instruments.

(2) *By fiduciaries.* A return with respect to income required to be made for a corporation by a fiduciary, pursuant to the provisions of section 6012(b)(3), shall be signed by such fiduciary. See paragraph (b)(4) of § 1.6012–3.

(3) *By agents.* A return with respect to income required to be made by an agent for a foreign corporation, which

has no office or place of business in the United States, shall be signed by such agent. See paragraph (g)(4) of § 1.6012–2.

(b) *Statements and other documents.* Statements and other documents required to be made by or for corporations under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A, shall be signed in accordance with the regulations contained in this chapter, or the forms and instructions, issued with respect to such statements or other documents.

(c) *Evidence of authority to sign.* An individual's signature on a return, statement, or other document made by or for a corporation shall be prima facie evidence that such individual is authorized to sign such return, statement, or other document.

(d) *Related provisions.* For the rules relating to the verification of returns, see § 1.6065–1.

§ 1.6063 Statutory provisions; signing of partnership returns.

SEC. 6063. *Signing of partnership returns.* The return of a partnership made under section 6031 shall be signed by any one of the partners. The fact that a partner's name is signed on the return shall be prima facie evidence that such partner is authorized to sign the return on behalf of the partnership.

§ 1.6063–1 Signing of returns, statements, and other documents made by partnerships.

(a) *In general.* Returns, statements, and other documents required to be made by partnerships under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A of the Code shall be signed by any one of the partners. However, with respect to the signing of powers of attorney, see paragraph (a)(2) of § 601.504 of this chapter (Statement of Procedural Rules).

(b) *Evidence of authority to sign.* A partner's signature on a return, statement, or other document made by or for a partnership of which he is a member shall be prima facie evidence that such partner is authorized to sign such return, statement, or other document.

§ 1.6065 Statutory provisions; verification of returns.

SEC. 6065. *Verification of returns—(a) Penalties of perjury.* Except as otherwise provided by the Secretary or his delegate, any return, declaration, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall contain or be verified by a written declaration that it is made under the penalties of perjury.

(b) *Oath.* The Secretary or his delegate may by regulations require that any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall be verified by an oath. This subsection shall not apply to returns and declarations with respect to income taxes made by individuals.

§ 1.6065–1 Verification of returns.

(a) *Persons signing returns.* If a return, declaration, statement, or other document made under the provisions of subtitle A or F of the Code, or the regulation thereunder, with respect to any tax imposed by subtitle A of the Code is required by the regulations contained in this chapter, or the form and instructions, issued with respect to such return, declaration, statement, or other document, to contain or be verified by a written declaration that it is made under the penalties of perjury, such return, declaration, statement, or other document shall be so verified by the person signing it.

(b) *Persons preparing returns—(1) In general.* Except as provided in subparagraph (2) of this paragraph, if a return, declaration, statement, or other document is prepared for a taxpayer by another person for compensation or as an incident to the performance of other services for which such person receives compensation, and the return, declaration, statement, or other document requires that it shall contain or be verified by a written declaration that it is prepared under the penalties of perjury, the preparer must so verify the return, declaration, statement, or other document. A person who renders mere mechanical assistance in the preparation of a return, declaration, statement, or other document as, for example, a stenographer or typist, is not considered as preparing the return, declaration, statement, or other document.

(2) *Exception.* The verification required by subparagraph (1) of this paragraph is not required on returns, declarations, statements, or other documents which are prepared—

(i) For an employee either by his employer or by an employee designated for such purpose by the employer, or

(ii) For an employer as a usual incident of the employment of one regularly or continuously employed by such employer.

TIME FOR FILING RETURNS AND OTHER DOCUMENTS

§ 1.6071 Statutory provisions; time for filing returns and other documents.

SEC. 6071. *Time for filing returns and other documents*—(a) *General rule.* When not otherwise provided for by this title, the Secretary or his delegate shall by regulations prescribe the time for filing any return, statement, or other document required by this title or by regulations.

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§ 1.6071–1 Time for filing returns and other documents.

(a) *In general.* Whenever a return, statement, or other document is required to be made under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A of the Code, and the time for filing such return, statement, or other document is not provided for by the Code, it shall be filed at the time prescribed by the regulations contained in this chapter with respect to such return, statement, or other document.

(b) *Return for a short period.* In the case of a return with respect to tax under subtitle A of the Code for a short period (as defined in section 443), the district director may, upon a showing by the taxpayer of unusual circumstances, prescribe a time for filing the return for such period later than the time when such return would otherwise be due.

(c) *Time for filing certain information returns.* (1) For provisions relating to the time for filing returns of partnership income, see paragraph (e)(2) of § 1.6031–1.

(2) For provisions relating to the time for filing information returns by banks with respect to common trust funds, see § 1.6032–1.

(3) For provisions relating to the time for filing information returns by certain organizations exempt from taxation under section 501(a), see paragraph (e) of § 1.6033–1.

(4) For provisions relating to the time for filing information returns by trusts claiming charitable deductions under section 642(c), see paragraph (c) of § 1.6034–1.

(5) For provisions relating to the time for filing information returns by officers, directors, and shareholders of foreign personal holding companies, see §§ 1.6035–1 and 1.6035–2.

(6) For provisions relating to the time for filing information returns by persons making certain payments, see § 1.6041–6.

(7) For provisions relating to the time for filing information returns regarding corporate dividends, earnings, profits, and ownership of stock, see paragraph (d) of § 1.6042–1.

(8) For provisions relating to the time for filing information returns by corporations with respect to contemplated dissolution or liquidation, see paragraph (a) of § 1.6043–1.

(9) For provisions relating to the time for filing information returns by corporations with respect to distributions in liquidation, see paragraph (a) of § 1.6043–2.

(10) For provisions relating to the time for filing information returns with respect to payments of patronage dividends, see paragraph (b) of § 1.6044–1.

(11) For provisions relating to the time for filing information returns with respect to formation or reorganization of foreign corporations, see § 1.6046–1.

§ 1.6072 Statutory provisions; time for filing income tax returns.

SEC. 6072. *Time for filing income tax returns*—(a) *General rule.* In the case of returns under section 6012, 6013, 6017, or 6031 (relating to income tax under subtitle A), returns made on the basis of the calendar year shall be filed on or before the 15th day of April following the close of the calendar year and returns made on the basis of a fiscal year shall be filed on or before the 15th day of the fourth month following the close of the fiscal year, except as otherwise provided in the following subsections of this section.

(b) *Returns of corporations.* Returns of corporations under section 6012 made on the basis of the calendar year shall be filed on or before the 15th day of March following the close of the calendar year, and such returns made on the basis of a fiscal year shall be filed on or before the 15th day of the third month following the close of the fiscal year.

(c) *Returns by certain nonresident alien individuals and foreign corporations.* Returns made by nonresident alien individuals (other than those whose wages are subject to withholding under chapter 24) and

foreign corporations (other than those having an office or place of business in the United States) under section 6012 on the basis of a calendar year shall be filed on or before the 15th day of June following the close of the calendar year and such returns made on the basis of a fiscal year shall be filed on or before the 15th day of the 6th month following the close of the fiscal year.

(d) *Returns of exempt cooperative associations.* In the case of income tax returns of exempt cooperative associations taxable under the provisions of section 522, returns made on the basis of a calendar year shall be filed on or before the 15th day of September following the close of the calendar year and returns made on the basis of a fiscal year shall be filed on or before the 15th day of the 9th month following the close of the fiscal year.

(e) *Income tax due dates postponed in case of China Trade Act corporations.* In the case of any taxable year beginning after December 31, 1948, and ending before October 1, 1956, no Federal income tax return of any corporation organized under the China Trade Act, 1922 (42 Stat. 849, U.S.C. title 15, chapter 4), as amended, shall become due until December 31, 1956, but only with respect to any such corporation and any such taxable year which the Secretary or his delegate may determine reasonable under the circumstances in China pursuant to such regulations as may be prescribed. Such due date shall be subject to the power of the Secretary or his delegate to extend the time for filing such return, as in other cases.

§ 1.6072–1 Time for filing returns of individuals, estates, and trusts.

(a) *In general.* Except as provided in paragraphs (b) and (c) of this section, returns of income required under sections 6012, 6013, 6014, and 6017 of individuals, estates, and trusts (including unrelated business tax returns of domestic and foreign trusts referred to in section 511 (b)(2)) shall be filed on or before the fifteenth day of the fourth month following the close of the taxable year.

(b) *Decedents.* In the case of a final return of a decedent for a fractional part of a year, the due date of such return shall be the fifteenth day of the fourth month following the close of the 12-month period which began with the first day of such fractional part of the year.

(c) *Nonresident alien individuals.* The income tax return of a nonresident alien individual shall be filed on or before the fifteenth day of the sixth month following the close of the taxable year. However, a nonresident alien individual who for the taxable year has wages subject to withholding under chapter 24 of the Code shall file his income tax return on or before the fifteenth day of the fourth month following the close of the taxable year.

(d) *Last day for filing return.* For provisions relating to the time for filing a return where the last day for filing falls on Saturday, Sunday, or a legal holiday, see section 7503 and § 301.7503–1 of this chapter (Regulations on Procedure and Administration).

§ 1.6072–2 Time for filing returns of corporations.

(a) *Domestic and certain foreign corporations.* The income tax return required under section 6012 of a domestic corporation or of a foreign corporation having an office or place of business in the United States shall be filed on or before the fifteenth day of the third month following the close of the taxable year.

(b) *Foreign corporations not having an office or place of business in the United States.* The income tax return of a foreign corporation which does not have an office or place of business in the United States shall be filed on or before the fifteenth day of the sixth month following the close of the taxable year.

(c) *Organizations having unrelated business income taxable at corporation rates.* The provisions of paragraph (a) or (b) of this section apply to organizations referred to in section 511(a)(2) and required to file a return of unrelated business taxable income.

(d) *Exempt cooperative associations.* The income tax return of an exempt cooperative association taxable under the provisions of section 522 shall be filed on or before the fifteenth day of the ninth month following the close of the taxable year.

(e) *Cross references.* For provisions relating to the time for filing a return where the last day for filing falls on Saturday, Sunday, or a legal holiday, see section 7503 and § 301.7503–1 of this chapter (Regulations on Procedure and Administration). For provisions relating to the fixing of a later time for filing in the case of a return for a short period, see paragraph (b) of § 1.6071–1. For provisions relating to time for filing consolidated returns, see paragraph (a) of § 1.1502–12.

§ 1.6072–3 Income tax due dates postponed in case of China Trade Act corporations.

(a) With respect to a taxable year beginning after December 31, 1948, and ending before October 1, 1956, the income tax return of any corporation organized under the China Trade Act of 1922 (15 U.S.C. ch. 4), as amended, shall not become due until December 31, 1956, provided that during any such taxable year conditions in China have been generally so unsettled as to militate against the normal commercial operations and corporate activities of such corporation. However, the postponement of the due date shall not apply to an income tax return for any such taxable year if—

(1) The books of account and business records are available so as to permit the filing of a proper return, and the corporation has otherwise been in a position to carry on its commercial operations and corporate activities and to make a proper distribution of its earnings or profits, if any, so as to permit the certification required by section 941 (b); or

(2) All the commercial operations and corporate activities of such corporation have been carried on in Hong Kong, Macao, or Taiwan (Formosa).

(b) Notwithstanding the provisions of paragraph (a) (1) or (2) of this section, the postponed due date referred to in this section will apply if a corporation satisfies the Commissioner that special circumstances exist, related to the unsettled conditions in China, which warrant such postponement.

(c) The postponed due date provided for in this section is expressly subject to the power of the Commissioner to extend, as in other cases, the time for filing the income tax return. See section 6081 and the regulations thereunder.

§ 1.6072–4 Time for filing other returns of income.

(a) *Returns of tax withheld from nonresident aliens and foreign corporations, and on tax-free covenant bonds.* For the time for filing returns with respect to tax withheld under chapter 3 of the Code, see §§ 1.1461–1 to 1.1461–3, inclusive.

(b) *Reports for recovery of excessive profits on Government contracts.* For the time for filing annual reports by persons completing Government contracts, see 26 CFR (1939) 17.16 (Treasury Decision 4906, approved June 23, 1939), and 26 CFR (1939) 16.15 (Treasury Decision 4909, approved June 28, 1939, as made applicable to section 1471 of the Internal Revenue Code of 1954 by Treasury Decision 6091, approved August 16, 1954 (19 F.R. 5167, C.B. 1954–2, 47).

(c) *Returns of tax on transfers to avoid income tax.* For the time for filing returns of tax under chapter 5 of the Code, see § 1.1494–1.

§ 1.6073 Statutory provisions; time for filing declarations of estimated income tax by individuals.

SEC. 6073. *Time for filing declarations of estimated income tax by individuals*—(a) *Individuals other than farmers.* Declarations of estimated tax required by section 6015 from individuals not regarded as farmers for the purpose of that section shall be filed on or before April 15 of the taxable year, except that if the requirements of section 6015 are first met—

(1) After April 1 and before June 2 of the taxable year, the declaration shall be filed on or before June 15 of the taxable year, or

(2) After June 1 and before September 2 of the taxable year, the declaration shall be filed on or before September 15 of the taxable year, or

(3) After September 1 of the taxable year, the declaration shall be filed on or before January 15 of the succeeding taxable year.

(b) *Farmers.* Declarations of estimated tax required by section 6015 from individuals whose estimated gross income from farming (including oyster farming) for the taxable year is at least two-thirds of the total estimated gross income from all sources for the taxable year may, in lieu of the time prescribed in subsection (a), be filed at any time on or before January 15 of the succeeding taxable year.

(c) *Amendment.* An amendment of a declaration may be filed in any interval between installment dates prescribed for that taxable year, but only one amendment may be filed in each such interval.

(d) *Short taxable years.* The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

(e) *Fiscal years.* In the application of this section to the case of a taxable year beginning on any date other than January 1, there shall be substituted, for the months specified in this section, the months which correspond thereto.

§ 1.6073–1 Time and place for filing declarations of estimated income tax by individuals.

(a) *Individuals other than farmers.* Declarations of estimated tax for the calendar year shall be made on or before April 15th of such calendar year by every individual whose anticipated income for the year meets the requirements of section 6015(a). If, however, the requirements necessitating the filing of the declaration are first met, in the case of an individual on the calendar year basis, after April 1st, but before June 2d of the calendar year, the declaration must be filed on or before June 15th; if such requirements are first met after June 1st and before September 2d, the declaration must be filed on or before September 15th; and if such requirements are first met after September 1st, the declaration must be filed on or before January 15th of the succeeding calendar year. In the case of an individual on the fiscal year basis, see § 1.6073–2.

(b) *Farmers.* In the case of an individual on a calendar year basis, whose estimated gross income from farming (including oyster farming) for the calendar year is at least two-thirds of his total estimated gross income from all sources for such year, his declaration may be filed on or before the 15th day of January of the succeeding calendar year in lieu of the time prescribed in paragraph (a) of this section. For the filing of a return in lieu of a declaration, see paragraph (a) of § 1.6015 (f)–1. The estimated gross income from farming (including oyster farming) is the estimated income resulting from the cultivation of the soil and the raising or harvesting of any agricultural or horticultural commodities, and the raising of livestock, bees, or poultry. In other words, the requisite gross income must be derived from the operations of a stock, dairy, poultry, fruit, or truck farm, or plantation, ranch, nursery, range, orchard, or oyster bed. If an individual receives for the use of his land income in the form of a share of the crops produced thereon such income is from farming. As to determination of income of farmers, see sections 61 and 162 and the regulations thereunder.

(c) *Place for filing declaration.* The declaration of estimated tax shall be filed with the district director for the district in which the taxpayer expects to file his income tax return.

(d) *Amendment of declaration.* An amended declaration of estimated tax may be filed during any interval between installment dates prescribed for the taxable year. However, no amendment declaration may be filed until after the installment date on or before which the original declaration was filed and only one amended declaration may be filed during each interval between installment dates. An amended declaration shall be filed with the district director with whom the original declaration was filed.

§ 1.6073–2 Fiscal years.

(a) *Individuals other than farmers.* In the case of an individual on the fiscal year basis, the declaration must be filed on or before the 15th day of the 4th month of the taxable year. If, however, the requirements of section 6015(a) are first met after the 1st day of the 4th month and before the 2d day of the 6th month, the declaration must be filed on or before the 15th day of the 6th month of the taxable year. If such requirements are first met after the 1st day of the 6th month, and before the 2d day of the 9th month, the declaration must be filed on or before the 15th day of the 9th month of the taxable year. If such requirements are first met after the 1st day of the 9th month, the declaration must be filed on or before the 15th day of the 1st month of the succeeding fiscal year. Thus, if an individual taxpayer has a fiscal year ending on June 30, 1956, his declaration must be filed on or before October 15, 1955, if the requirements of section 6015 (a) are met on or before October 1, 1955. If, however, such requirements are not met until after October 1, 1955, and before December 2, 1955, the declaration need not be filed until December 15, 1955.

(b) *Farmers.* An individual on the fiscal year basis whose estimated gross income from farming (as defined in paragraph (b) of § 1.6073–1) is at least two-thirds of his total estimated gross income from all sources for such taxable year may file his declaration on or before the 15th day of the month immediately following the close of his taxable year.

§ 1.6073–3 Short taxable years.

(a) *Individuals other than farmers.* In the case of short taxable years the declaration shall be filed on or before the 15th day of the 4th month of such taxable year if the requirements of section 6015(a) are met on or before the 1st day of the 4th month of such year. If such requirements are first met after the 1st day of the 4th month but before the 2d day of the 6th month, the declaration must be filed on or before the 15th day of the 6th month. If such requirements are first met after the 1st day of the 6th month but before the 2d day of the 9th month, the declaration must be filed on or before the 15th day of the 9th month. If, however, the period for which the declaration is filed is one of 4 months, or one of 6 months and the requirements of section 6015 (a) are not met until after the 1st day of the 4th month, or one of 9 months and such requirements are not met until after the 1st day of the 6th month, the declaration may be filed on or before the 15th day of the succeeding taxable year.

(b) *Farmers.* In the case of an individual whose estimated gross income from farming (as defined in paragraph (b) of § 1.6073–1) for a short taxable year is at least two-thirds of his total estimated gross income from all sources for such taxable year, his declaration may be filed on or before the 15th day of the month immediately following the close of such taxable year.

§ 1.6073–4 Extension of time for filing declarations by individuals.

(a) *In general.* District directors are authorized to grant a reasonable extension of time for filing a declaration or an amended declaration. An application for an extension of time for filing such a declaration shall be addressed to the district director for the district in which the taxpayer is required to file his declaration, and must contain a full recital of the causes for the delay. Except in the case of taxpayers who are abroad, no extension for filing declarations may be granted for more than six months.

(b) *Citizens outside of the United States.* In the case of a United States citizen outside the continental United States, Hawaii, and Puerto Rico on the 15th day of the 4th month of his taxable year, an extension of time for filing his declaration of estimated tax otherwise due on or before the 15th day of the 4th month of the taxable year is granted to and including the 15th day of the 6th month of the taxable year. As used in this paragraph, the term "continental United States" does not include Alaska.

(c) *Addition to tax applicable.* An extension of time for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. However, such extension does not relieve the taxpayer from the addition to the tax imposed by section 6654, and the period of the underpayment will be determined under section 6654 (c) without regard to such extension.

§ 1.6074 Statutory provisions; time for filing declarations of estimated income tax by corporations.

SEC. 6074. *Time for filing declarations of estimated income tax by corporations*—(a) *General rule.* The declaration of estimated tax required of corporations by section 6016 shall be filed on or before the 15th day of the 9th month of the taxable year, except that if the requirements of section 6016 are first met after the last day of the 8th month and before the 1st day of the 12th month of the taxable year, the declaration shall be filed on or before the 15th day of the 12th month of the taxable year.

(b) *Amendment.* If a declaration is filed before the 15th day of the 12th month of the taxable year, an amendment of such declaration may be filed on or before such day.

(c) *Short taxable year.* The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.6074–1 Time and place for filing declarations of estimated income tax by corporations.

(a) *In general.* For taxable years ending on and after December 31, 1955, declarations of estimated tax for the taxable year shall be filed on or before the 15th day of the 9th month of such year by every corporation whose then anticipated income tax liability under section 11, or section 1201(a), or subchapter L, chapter 1 of the Code, for the year meets the requirements of section 6016 (a). If, however, the requirements necessitating the filing of a declaration are first met after the last day of the 8th month and before the first day of the 12th month of the taxable year the declaration must be filed on or before the 15th day of the 12th month of the taxable year. If, however, the requirements of section 6016 (a) are not met

before the first day of the 12th month of the taxable year, no declaration need be filed for such year.

(b) *Place for filing declaration.* The declaration of estimated tax shall be filed with the district director for the district in which the corporation expects to file its income tax return.

(c) *Amendment of declaration.* A declaration of estimated tax filed by a corporation prior to the 15th day of the 12th month of the taxable year may be amended, in the manner prescribed in § 1.6016–3, at any time on or before such 15th day. An amended declaration shall be filed with the district director with whom the original declaration was filed.

§ 1.6074–2 Time for filing declarations by corporations in case of a short taxable year.

(a) *In general.* In the case of a short taxable year of 9 months or more, where the requirements of section 6016 (a) are met before the 1st day of the 9th month of the short taxable year, the declaration shall be filed on or before the 15th day of the 9th month of such short year. In the case of a short taxable year of more than 9 months, where the requirements of section 6016 (a) are first met after the last day of the 8th month, but before the 1st day of the last month of the short taxable year, the declaration shall be filed on or before the 15th day of the last month of such short year. See § 1.6016–4, relating to the requirement of a declaration in the case of a short taxable year, and § 1.6154–2, relating to the time for payment of the estimated tax in case of a short taxable year.

(b) *Amendment of declaration.* A declaration of estimated tax for a short taxable year of more than 9 months filed by a corporation before the 15th day of the last month of the short taxable year may be amended, in the manner prescribed in § 1.6016–3, any time on or before such 15th day.

(c) *Example.* The application of the provisions of this section may be illustrated by the following example:

Example. A corporation which changes from a calendar year basis to a fiscal year basis beginning November 1 will have a short taxable year beginning January 1 and ending October 31. If the requirements of section 6016 (a) are met before September 1 (the 1st day of the 9th month) the corporation is required to file its declaration on or before September 15 (the 15th day of the 9th month). However, if the requirements of section 6016 (a) are first met after August 31 (the last day of the 8th month) but before October 1 (the 1st day of the last month of the short year) the corporation would be required to file its declaration on or before October 15 (the 15th day of the last month of the short year).

§ 1.6074–3 Extension of time for filing declarations by corporations.

(a) *In general.* District directors are authorized to grant a reasonable extension of time for filing a declaration or an amended declaration. An application by a corporation for an extension of time for filing such a declaration shall be addressed to the district director for the district in which the corporation is required to file its declaration, and must contain a full recital of the causes for the delay.

(b) *Addition to tax applicable.* An extension of time granted to a corporation for filing a declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. However, such extension does not relieve the corporation from the addition to the tax imposed by section 6655, and the period of the underpayment will be determined under section 6655 (c) without regard to such extension.

EXTENSION OF TIME FOR FILING RETURNS

§ 1.6081 Statutory provisions; extension of time for filing returns.

SEC. 6081. *Extension of time for filing returns*—(a) *General rule.* The Secretary or his delegate may grant a reasonable extension of time for filing any return, declaration, statement, or other document required by this title or by regulations. Except in the case of taxpayers who are abroad, no such extension shall be for more than 6 months.

(b) *Automatic extension for corporation income tax returns.* An extension of 3 months for the filing of the return of income taxes imposed by subtitle A shall be allowed any corporation if, in such manner and at such time as the Secretary or his delegate may by regulations prescribe, there is filed on behalf of such corporation the form prescribed by the Secretary or his delegate, and if such corporation pays, on or before the date prescribed for payment of the tax, the amount properly estimated as its tax or the first installment thereof required under section 6152; but this extension may be terminated at any time by the Secretary or his delegate by mailing to the taxpayer notice of such termination at least 10 days prior to the date for termination fixed in such notice.

(c) *Postponement by reason of war.* For time for performing certain acts postponed by reason of war, see section 7508.

§ 1.6081–1 Extension of time for filing returns.

(a) *In general.* District directors, including the Director of International Operations, are authorized to grant a reasonable extension of time for filing any return, declaration, statement, or other document which relates to any tax imposed by subtitle A of the Code and which is required under the provisions of subtitle A or F of the Code or the regulations thereunder. However, except in the case of taxpayers who are abroad, such extensions of time shall not be granted for more than six months. Except in the case of declarations of estimated income tax, an extension of time for filing an income tax return does not operate to extend the time for the payment of the tax, or any installment thereof, unless so specified in the extension. For extension of time for filing declarations of estimated tax, see §§ 1.6073–4 and 1.6074–3. For extension of time for paying tax, see § 1.6161–1.

(b) *Application for extension of time*—(1) *In general.* A taxpayer desiring an extension of the time for filing a return, statement, or other document shall submit an application therefor on or before the due date of such return, statement, or other document. Except as provided in subparagraph (3) of this paragraph, such application shall be made to the internal revenue officer with whom such return, statement, or other document is required to be filed. Such application shall be in writing, properly signed by the taxpayer or his duly authorized agent, and shall clearly set forth (i) the particular tax return, information return, statement, or other document, including the taxable year or period thereof, with respect to which the extension of the time for filing is desired, and (ii) a full recital of the reasons for requesting the extension to aid such internal revenue officer in determining the period of extension, if any, which will be granted.

(2) *Additional information in the case of Form 1040 or Form 1040W.* In addition to the information required under subparagraph (1) of this paragraph, the application of a taxpayer desiring an extension of the time for filing an individual income tax return on Form 1040 or Form 1040W for any taxable year beginning after December 31, 1958, shall also set forth (i) whether an income tax return has been filed on or before its due date for each of the three taxable years immediately preceding the taxable year of such return, and if not, the reason for each failure, and (ii) whether the taxpayer was required to file a declaration of estimated tax for the taxable year of such return, and if so, whether each required estimated tax payment was made on or before its due date. For purposes of this subparagraph a return is considered as filed on or before its due date if it is filed on or before the applicable date provided in section 6072 or on or before the last day of the period covered by an extension of time granted pursuant to the provisions of section 6081, and each required payment of estimated tax is considered as paid on or before its due date if it is paid on or before the applicable date provided in section 6153 or on or before the last day of the period covered by an extension of time granted pursuant to the provisions of section 6161.

(3) *Information returns filed with Service Center.* An application for an extension of the time for filing any information return required to be filed with an Internal Revenue Service Center shall state the location of the Service Center with which such return will be filed. Such application shall be made to the internal revenue officer with whom the applicant is required to file an income tax return or with whom the applicant would be required to file an income tax return if such a return were required of him.

(4) *Taxpayer unable to sign.* In any case in which a taxpayer is unable, by reason of illness, absence, or other good cause, to sign a request for an extension, any person standing in close personal or business relationship to the taxpayer may sign the request on his behalf, and shall be considered as a duly authorized agent for this purpose, provided the request sets forth the reasons for a signature other than the taxpayer's and the relationship existing between the taxpayer and the signer.

(5) *Form of application.* The application for an extension of the time for filing a return, statement, or other docu-

ment may be made in the form of a letter. However, in the case of an individual income tax return on Form 1040 or Form 1040W, the application for an extension of the time for filing may be made either on Form 2688 or in the form of a letter.

§ 1.6081–2 Extensions of time in the case of foreign organizations, certain domestic corporations, certain partnerships, and citizens of United States residing or traveling abroad.

(a) *In general.* An extension of time for filing returns of income is hereby granted up to and including the fifteenth day of the sixth month following the close of the taxable year in the case of:

(1) Partnerships which are required under paragraph (e) (2) of § 1.6031–1 to file returns on the fifteenth day of the fourth month following the close of the taxable year of the partnership, and which keep their records and books of account abroad;

(2) Domestic corporations which transact their business and keep their records and books of account abroad;

(3) Foreign corporations which maintain an office or place of business within the United States;

(4) Domestic corporations whose principal income is from sources within the possessions of the United States; and

(5) American citizens residing or traveling abroad, including persons in military or naval service on duty outside the United States.

In all such cases a statement must be attached to the return showing that the person for whom the return is made is a person described in this section.

(b) *Definitions.* The term "abroad", as used in this section, means outside the continental United States, Hawaii, and Puerto Rico. For purposes of this paragraph, the term "continental United States" does not include Alaska.

§ 1.6081–3 Automatic extension of time for filing corporation income tax returns.

(a) *In general.* A corporation shall be allowed an automatic extension of time to the fifteenth day of the third month following the month in which falls the date prescribed for the filing of its income tax return provided the following requirements are met:

(1) An application must be prepared in duplicate on Form 7004, "Application for Automatic Extension of Time to File U.S. Corporation Income Tax Return", and must be signed by a person authorized by the corporation to request such extension, and such person must be either an officer of the corporation or a person currently enrolled to practice before the Treasury Department.

(2) The original of the application must be filed on or before the date prescribed for the filing of the return of the corporation with the internal revenue officer with whom the corporation is required to file its income tax return and must be accompanied by a remittance of an estimated amount of tax which shall not be less than would be required as the first installment under section 6152 (a) (1) should the corporation elect to pay the tax in installments.

Upon the timely filing of Form 7004, properly prepared, the three-month extension shall be considered as allowed. If the taxpayer elects to pay in installments the tax shown on Form 7004, the installment privilege provided in section 6152(a)(1) is limited to the amount shown on the form. The duplicate Form 7004 shall be attached to the completed income tax return when filed as evidence of the extension.

(b) *Consolidated returns.* An application for an automatic extension of time for filing a consolidated return shall be made by a person authorized by the parent corporation to request such extension. Such person must be either an officer of the parent corporation or a person currently enrolled to practice before the Treasury Department. There shall be attached to such application a statement listing the name and address of each member of the affiliated group for which such consolidated return will be made. The original of such application shall be filed with the district director for the district in which the parent corporation is required to file its income tax return. If a member of the affiliated group would be required to file its separate income tax return with a district director other than the district director with whom the parent corporation files its return, the parent corporation must immediately send to each district director with whom such member would be required to file its return a written notice that an application for the automatic extension of time for filing the consolidated return has been filed. Such notice shall also indicate the name and address of each member of the affiliated group required to file its separate return with such district director, and the name and address of the district director with whom the consolidated return will be filed. Upon the timely filing of Form 7004 in the office of the district director with whom the parent corporation files its return, and notices in the offices of the district directors with whom the members of the affiliated group file their returns, the three-month extension shall be considered as granted to the affiliated group for the filing of its consolidated return or for the filing of each member's separate return. In the event that the privilege of filing a consolidated return is not exercised, the parent corporation, and members of the affiliated group filing in the same district as that in which the parent files, shall attach to their completed separate income tax returns a copy of the application (Form 7004); and each other member of the affiliated group shall attach to its completed separate income tax return a copy of the notice sent to the district director with whom its return is filed.

(c) *Termination of automatic extension.* The district director, including the Director of International Operations, may, in his discretion, terminate at any time an automatic extension by mailing to the corporation (parent corporation in the case of an affiliated group), or the person who requested such extension for the corporation, a notice of termination. The notice shall be mailed at least ten days prior to the termination date designated in such notice. The notice of termination shall be sufficient for all purposes when mailed to the corporation at its address shown on Form 7004 or to the person who requested such extension for the corporation at his last known address or last known place of business, even if such corporation has terminated its existence, or such person is deceased or is under a legal disability.

PLACE FOR FILING RETURNS OR OTHER DOCUMENTS

§ 1.6091 Statutory provisions; place for filing returns or other documents.

SEC. 6091. *Place for filing returns or other documents*—(a) *General rule.* When not otherwise provided for by this title, the Secretary or his delegate shall by regulations prescribe the place for the filing of any return, declaration, statement, or other document, or copies thereof, required by this title or by regulations.

(b) *Tax returns.* In the case of returns of tax required under authority of part II of this subchapter—

(1) *Individuals.* Returns (other than corporation returns) shall be made to the Secretary or his delegate in the internal revenue district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in any internal revenue district, then at such place as the Secretary or his delegate may by regulations prescribe.

(2) *Corporations.* Returns of corporations shall be made to the Secretary or his delegate in the internal revenue district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in any internal revenue district, then at such place as the Secretary or his delegate may by regulations prescribe.

* * * * *

(4) *Exceptional cases.* Notwithstanding paragraph (1), (2), or (3) of this subsection, the Secretary or his delegate may permit a return to be filed in any internal revenue district, and may require the return of any officer or employee of the Treasury Department to be filed in any internal revenue district selected by the Secretary or his delegate.

§ 1.6091–1 Place for filing returns or other documents.

(a) *In general.* Except as provided in § 1.6091–4, whenever a return, statement, or other document is required to be made under the provisions of subtitle A or F of the Code, or the regulations thereunder, with respect to any tax imposed by subtitle A of the Code, and the place for filing such return, statement, or other document is not provided for by the Code, it shall be filed at the place prescribed by the regulations contained in this chapter.

(b) *Place for filing certain information returns.* (1) For the place for filing returns of partnership income, see paragraph (e)(1) of § 1.6031–1.

(2) For the place for filing information returns by banks with respect to common trust funds, see § 1.6032–1.

(3) For the place for filing information returns by certain organizations exempt from taxation under section 501 (a), see paragraph (e) of § 1.6033–1.

(4) For the place for filing information returns by trusts claiming chari-

table deductions under section 642(c), see paragraph (c) of § 1.6034–1.

(5) For the place for filing information returns by officers, directors, and shareholders of foreign personal holding companies, see paragraph (d) of § 1.6035–1 and paragraph (d) of § 1.6035–2.

(6) For the place for filing returns of information reporting certain payments on Forms 1099 and 1096, see § 1.6041–6.

(7) For the place for filing information returns regarding corporate dividends, earnings, and profits on Forms 1099 and 1096, and regarding ownership of stock on Form 1087, see paragraph (d) of § 1.6042–1.

(8) For the place for filing information returns by corporations relating to contemplated dissolution or liquidation, see paragraph (a) of § 1.6043–1.

(9) For the place for filing information returns by corporations relating to distributions in liquidation, see paragraph (a) of § 1.6043–2.

(10) For the place for filing information returns reporting payments of patronage dividends, see paragraph (b) of § 1.6044–1.

(11) For the place for filing information returns relating to formation or reorganization of foreign corporations, see paragraph (e) of § 1.6046–1.

§ 1.6091–2 Place for filing income tax returns.

(a) *Individuals, estates, and trusts.* (1) Except as provided in §§ 1.6091–3 and 1.6091–4, income tax returns of individuals, estates, and trusts shall be filed with the district director for the internal revenue district in which is located the legal residence or principal place of business of the person required to make the return, or, if such person has no legal residence or principal place of business in any internal revenue district, with the District Director, Baltimore 2, Maryland.

(2) An individual employed on a salary or commission basis who is not also engaged in conducting a commercial or professional enterprise for profit on his own account does not have a "principal place of business" within the meaning of this section.

(b) *Corporations.* Except as provided in §§ 1.6091–3 and 1.6091–4, income tax returns of corporations shall be filed with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation.

§ 1.6091–3 Income tax returns required to be filed with Director of International Operations.

The following income tax returns shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D.C., or at such other address as is designated on the return form or in the instructions issued with respect to such form:

(a) Income tax returns on which all, or a portion, of the tax is to be paid in foreign currency. See §§ 301.6316–1 to 301.6316–8, inclusive, of this chapter (Regulations on Procedure and Administration).

(b) Income tax returns of an individual citizen of the United States whose principal place of abode for the taxable year is outside the United States, and who has no legal residence or principal place of business in any internal revenue district in the United States.

(c) Income tax returns of an individual citizen of a possession of the United States (whether or not a citizen of the United States) who has no legal residence or principal place of business in any internal revenue district in the United States.

(d) Except in the case of any departing alien return under section 6851 and § 1.6851–2, the income tax return of any alien who has no legal residence or principal place of business in any internal revenue district in the United States.

(e) The income tax return of an estate or trust the fiduciary of which is outside the United States and has no legal residence or place of business in any internal revenue district in the United States.

(f) Income tax returns of foreign corporations having no principal place of business, or principal office or agency in any internal revenue district in the United States.

§ 1.6091–4 Exceptional cases.

(a) *Permission to file in district other than required district.* The Commissioner may permit the filing of any income tax return required to be made under the provisions of subtitle A or F of the Code, or the regulations in this part, in any internal revenue district, notwithstanding the provisions of paragraphs (1) and (2) of section 6091(b) and §§ 1.6091–1 to 1.6091–3, inclusive.

(b) *Returns of officers and employees of the Internal Revenue Service.* The Commissioner may require any officer or employee of the Internal Revenue Service to file his income tax return in any district selected by the Commissioner.

MISCELLANEOUS PROVISIONS

§ 1.6102 Statutory provisions; computations on returns or other documents.

SEC. 6102. *Computations on returns or other documents*—(a) *Amounts shown on internal revenue forms.* The Secretary or his delegate is authorized to provide with respect to any amount required to be shown on a form prescribed for any internal revenue return, statement, or other document, that if such amount of such item is other than a whole-dollar amount, either—

(1) The fractional part of a dollar shall be disregarded; or

(2) The fractional part of a dollar shall be disregarded unless it amounts to one-half dollar or more, in which case the amount (determined without regard to the fractional part of a dollar) shall be increased by $1.

(b) *Election not to use whole dollar amounts.* Any person making a return, statement, or other document shall be allowed, under regulations prescribed by the Secretary or his delegate, to make such return, statement, or other document without regard to subsection (a).

(c) *Inapplicability to computation of amount.* The provisions of subsections (a) and (b) shall not be applicable to items which must be taken into account in making the computations necessary to determine the amount required to be shown on a form, but shall be applicable only to such final amount.

§ 1.6102–1 Computations on returns or other documents.

For provisions with respect to the rounding off to whole-dollar amounts of money items on returns and accompanying schedules, see § 301.6102–1 of this chapter (Regulations on Procedure and Administration).

TIME AND PLACE FOR PAYING TAX

PLACE AND DUE DATE FOR PAYMENT OF TAX

§ 1.6151 Statutory provisions; time and place for paying tax shown on returns.

SEC. 6151. *Time and place for paying tax shown on returns*—(a) *General rule.* Except as otherwise provided in this section, when a return of tax is required under this title or regulations, the person required to make such return shall, without assessment or notice and demand from the Secretary or his delegate, pay such tax to the principal internal revenue officer for the internal revenue district in which the return is required to be filed, and shall pay such tax at the time and place fixed for filing the return (determined without regard to any extension of time for filing the return).

(b) *Exceptions*—(1) *Income tax not computed by taxpayer.* If the taxpayer elects under section 6014 not to show the tax on the return, the amount determined by the Secretary or his delegate as payable shall be paid within 30 days after the mailing by the Secretary or his delegate to the taxpayer of a notice stating such amount and making demand therefor.

(2) *Use of Government depositaries.* For authority of the Secretary or his delegate to require payments to Government depositaries, see section 6302(c).

(c) *Date fixed for payment of tax.* In any case in which a tax is required to be paid on or before a certain date, or within a certain period, any reference in this title to the date fixed for payment of such tax shall be deemed a reference to the last day fixed for such payment (determined without regard to any extension of time for paying the tax).

§ 1.6151–1 Time and place for paying tax shown on returns.

(a) *In general.* Except as provided in section 6152 and paragraph (b) of this section, the tax shown on any income tax return shall, without assessment or notice and demand, be paid to the internal revenue officer with whom the return is required to be filed at the time fixed for filing the return (determined without regard to any extension of time for filing the return). For provisions relating to the time for filing income tax returns, see section 6072 and §§ 1.6072–1 to 1.6072–4, inclusive. For provisions relating to the place for filing income tax returns, see section 6091 and §§ 1.6091–1 to 1.6091–4, inclusive.

(b) *Returns on Form 1040A*—(1) *Where tax is not shown on return.* In any case in which a taxpayer files a return on Form 1040A and, pursuant to section 6014 and § 1.6014–1, elects not to show the tax on the return, the amount of tax determined to be due shall be paid within 30 days after the date of mailing to the taxpayer a notice stating the amount payable and making demand upon the taxpayer therefor. However, if the notice is mailed to the taxpayer more than 30 days before the due date of the return, payment of the tax shall not be required prior to such due date.

(2) *Where tax is shown on the return.* In any case in which a taxpayer files a return on Form 1040A pursuant to para-

graph (a)(7) of § 1.6012–1 and shows the amount of tax on the return, the unpaid balance of the tax shall, without assessment or notice and demand, be paid not later than the date fixed for filing the return.

(c) *Date fixed for payment of tax.* In any case in which a tax imposed by subtitle A of the Code is required to be paid on or before a certain date, or within a certain period, any reference in subtitle A or F of the Code to the date fixed for payment of such tax shall be deemed a reference to the last day fixed for such payment (determined without regard to any extension of time for paying the tax).

§ 1.6152 Statutory provisions; installment payments.

SEC. 6152. *Installment payments*—(a) *Privilege to elect to make installment payments*—(1) *Corporations.* A corporation subject to the taxes imposed by chapter 1 may elect to pay the unpaid amount of such taxes in installments as follows:

(A) With respect to taxable years ending before December 31, 1954, four installments, the first two of which shall be 45 percent, respectively, of such taxes and the last two of which shall be 5 percent, respectively, of such taxes;

(B) With respect to taxable years ending on or after December 31, 1954, two equal installments.

(2) *Estates of decedents.* A decedent's estate subject to the tax imposed by chapter 1 may elect to pay such tax in four equal installments.

(b) *Dates prescribed for payment of installments*—(1) *Four installments.* In any case (other than payment of estimated income tax) in which the tax may be paid in four installments, the first installment shall be paid on the date prescribed for the payment of the tax, the second installment shall be paid on or before 3 months, the third installment on or before 6 months, and the fourth installment on or before 9 months, after such date.

(2) *Two installments.* In any case (other than payment of estimated income tax) in which the tax may be paid in two installments, the first installment shall be paid on the date prescribed for the payment of the tax, and the second installment shall be paid on or before 3 months after such date.

(c) *Proration of deficiency to installments.* If an election has been made to pay the tax imposed by chapter 1 in installments and a deficiency has been assessed, the deficiency shall be prorated to such installments. Except as provided in section 6861 (relating to jeopardy assessments), that part of the deficiency so prorated to any installment the date for payment of which has not arrived shall be collected at the same time as and as part of such installment. That part of the deficiency so prorated to any installment the date for payment of which has arrived shall be paid upon notice and demand from the Secretary or his delegate.

(d) *Acceleration of payment.* If any installment (other than an installment of estimated income tax) is not paid on or before the date fixed for its payment, the whole of the unpaid tax shall be paid upon notice and demand from the Secretary or his delegate.

[Sec. 6152 as amended by sec. 3, Act of Sept. 1, 1954 (Pub. Law 767, 83d Cong., 68 Stat. 1130)]

§ 1.6152–1 Installment payments.

(a) *Privilege of corporation to elect to make installment payments*—(1) *Amount to be paid.* In the case of any taxable year ending on or after December 31, 1954, a corporation subject to the taxes imposed by chapter 1 of the Code may elect, as provided in subparagraph (2) of this paragraph, to pay the unpaid amount of such tax for the taxable year in two equal installments instead of making a single payment. If such an election is made, the installments shall be paid as follows:

(i) Fifty percent on or before the date prescribed for the payment of the tax as a single payment, and

(ii) The remaining 50 percent on or before three months after the date prescribed for the payment of the first installment.

For provisions relating to installment payments of estimated income tax by corporations, see section 6154 and §§ 1.6154–1 to 1.6154–3, inclusive.

(2) *Method of election.* A corporation shall be considered to have made an election to pay its tax in installments if—

(i) It files its income tax return on or before the date prescribed therefor (determined without regard to any extension of time) and pays 50 percent of the unpaid amount of the tax at such time, or

(ii) It files an application on Form 7004 for an automatic extension of time to file its income tax return, as provided in § 1.6081–3, and pays 50 percent of the unpaid amount of the tax at such time. Except as provided in paragraph (c) of this section, the installment privilege is limited to the unpaid amount of tax as shown on the income tax return filed in accordance with the provisions of subdivision (i) of this subparagraph, or as shown on the Form 7004 filed in accordance with the provisions of this subdivision.

(b) *Privilege of estates of decedents to make installment payments.* With respect to the income tax imposed by chapter 1 of the Code upon estates of decedents, the fiduciary may elect to pay the tax in four equal installments instead of in a single payment. If the election is made, the tax shall be paid as follows:

(1) Twenty-five percent on or before the date prescribed for the payment of the tax as a single payment,

(2) Twenty-five percent on or before three months after the date prescribed for payment of the first installment,

(3) Twenty-five percent on or before six months after the date prescribed for payment of the first installment, and

(4) Twenty-five percent on or before nine months after the date prescribed for payment of the first installment.

(c) *Proration of deficiency to installments.* If an election has been made to pay the tax imposed by chapter 1 of the Code in installments, and a deficiency has been assessed, the deficiency shall be prorated equally to all the installments, whether paid or unpaid. Except as provided in section 6861, relating to jeopardy assessment, the part of the deficiency so prorated to any installment which is not yet due shall be collected at the same time as and as part of such installment. The part of the deficiency so prorated to any installment the date for payment of which has arrived shall be paid upon notice and demand from the district director.

(d) *Acceleration of payment.* If a taxpayer elects under the provisions of this section to pay the tax in installments, any installment may be paid prior to the date prescribed for its payment. If an installment is not paid in full on or before the date fixed for its payment the whole amount of the unpaid tax shall be paid upon notice and demand from the district director.

§ 1.6153 Statutory provisions; installment payments of estimated income tax by individuals.

SEC. 6153. *Installment payments of estimated income tax by individuals*—(a) *General rule.* The amount of estimated tax (as defined in section 6015 (c)) with respect to which a declaration is required under section 6015 shall be paid as follows:

(1) If the declaration is filed on or before April 15 of the taxable year, the estimated tax shall be paid in four equal installments. The first installment shall be paid at the time of the filing of the declaration, the second and third on June 15 and September 15, respectively, of the taxable year, and the fourth on January 15 of the succeeding taxable year.

(2) If the declaration is filed after April 15 and not after June 15 of the taxable year, and is not required by section 6073 (a) to be filed on or before April 15 of the taxable year, the estimated tax shall be paid in three equal installments. The first installment shall be paid at the time of the filing of the declaration, the second on September 15 of the taxable year, and the third on January 15 of the succeeding taxable year.

(3) If the declaration is filed after June 15 and not after September 15 of the taxable year, and is not required by section 6073 (a) to be filed on or before June 15 of the taxable year, the estimated tax shall be paid in two equal installments. The first installment shall be paid at the time of the filing of the declaration, and the second on January 15 of the succeeding taxable year.

(4) If the declaration is filed after September 15 of the taxable year, and is not required by section 6073 (a) to be filed on or before September 15 of the taxable year, the estimated tax shall be paid in full at the time of the filing of the declaration.

(5) If the declaration is filed after the time prescribed in section 6073 (a) (including cases in which an extension of time for filing the declaration has been granted under section 6081), paragraphs (2), (3), and (4) of this subsection shall not apply, and there shall be paid at the time of such filing all installments of estimated tax which would have been payable on or before such time if the declaration had been filed within the time prescribed in section 6073 (a), and the remaining installments shall be paid at the times at which, and in the amounts in which, they would have been payable if the declaration had been so filed.

(b) *Farmers.* If an individual referred to in section 6073 (b) (relating to income from farming) makes a declaration of estimated tax after September 15 of the taxable year and on or before January 15 of the succeeding taxable year, the estimated tax shall be paid in full at the time of the filing of the declaration.

(c) *Amendments of declaration.* If any amendment of a declaration is filed, the remaining installments, if any, shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease, as the case may be, in the estimated tax by reason of such amendment, and if any amendment is made after September 15 of

the taxable year, any increase in the estimated tax by reason thereof shall be paid at the time of making such amendment.

(d) *Application to short taxable years.* The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

(e) *Fiscal years.* In the application of this section to the case of a taxable year beginning on any date other than January 1, there shall be substituted, for the months specified in this section, the months which correspond thereto.

(f) *Installments paid in advance.* At the election of the individual, any installment of the estimated tax may be paid prior to the date prescribed for its payment.

§ 1.6153–1 Payment of estimated tax by individuals.

(a) *In general.* (1) The time for payment of the estimated tax by individuals for calendar years shall be as follows:

Date of filing declaration	*Dates of payment of estimated tax*
(i) On or before April 15	In 4 equal installments—one at time of filing declaration, one on or before June 15, one on or before September 15, and one on or before January 15 of the succeeding taxable year.
(ii) After April 15 and before June 16 if not required to be filed on or before April 15.	In 3 equal installments—one at time of filing declaration, one on or before September 15, and one on or before January 15 of the succeeding taxable year.
(iii) After June 15 and before September 16 if not required to be filed on or before June 15.	In 2 equal installments—one at time of filing declaration, and the other on or before January 15 of the succeeding taxable year.
(iv) After September 15 if not required to be filed on or before September 15.	In full at time of filing declaration.

(2) If, for example, due to the nature and amount of his gross income for 1955, the taxpayer is not required to file his declaration as of April 15, but is required to file the declaration on or before June 15, 1955, the case comes within the scope of subparagraph (1) (ii) of this paragraph and the estimated tax is payable in 3 equal installments, the 1st on the date of filing, the 2d on or before September 15, 1955, and the 3d installment on or before January 15, 1956.

(3) If a declaration is filed after the time prescribed in section 6073 (a) (including any extension of time granted for filing the declaration), there shall be paid at such time all installments of the estimated tax which would have been payable on or before such date of filing if the declaration had been timely filed in accordance with the provisions of section 6073 (a). The remaining installments shall be paid at the times and in the amounts in which they would have been payable if the declaration had been timely filed. Thus, for example, B, a single man who makes his return on the calendar year basis, was employed from the beginning of 1955 and for several years prior thereto at an annual salary of $6,000, thus meeting the requirements of section 6015 (a). B filed his declaration for 1955 on September 16, 1955. In such case, B should have filed a declaration on or before April 15, 1955, and at the time of filing his declaration he was delinquent in the payment of three installments of his estimated tax for the taxable year 1955. Hence, upon his filing the declaration on September 16, 1955, three-fourths of the estimated tax shown thereon must be paid.

(4) In the case of a decedent, payments of estimated tax are not required subsequent to the date of death. See, however, paragraph (c) of § 1.6015 (b)–1, relating to the making of an amended declaration by a surviving spouse if a joint declaration was made before the death of the decedent.

(5) The payment of any installment of the estimated tax shall be considered payment on account of the tax for such taxable year. Hence, upon the return for such taxable year, the aggregate amount of the payments of estimated tax should be entered as payments to be applied against the tax shown on such return.

(b) *Farmers.* Special provisions are made with respect to the filing of the declaration and the payment of the tax by an individual whose estimated gross income from farming is at least two-thirds of his total gross income from all sources for the taxable year. As to what constitutes income from farming within the meaning of this paragraph, see paragraph (b) of § 1.6073–1. The declaration of such an individual may be filed on or before January 15 of the succeeding taxable year in lieu of the time prescribed for individuals generally. Where such an individual makes a declaration of estimated tax after September 15 of the taxable year, the estimated tax shall be paid in full at the time of the filing of the declaration.

(c) *Amendment of declaration.* If any amendment of a declaration is filed, the remaining installments, if any, shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease in the estimated tax by reason of the amendment. If any amendment is made after September 15 of the taxable year, any increase in the estimated tax by reason thereof shall be paid at the time of making the amendment.

(d) *Installments paid in advance.* At the election of the taxpayer any installment of the estimated tax may be paid prior to the date prescribed for its payment.

§ 1.6153–2 Fiscal years.

In the case of an individual on the fiscal year basis, the dates prescribed for payment of the estimated tax shall be the 15th day of the 4th month, the 15th day of the 6th month, and the 15th day of the 9th month of the taxable year and the 15th day of the 1st month of the succeeding taxable year. For example, if an individual having a fiscal year ending on June 30, 1956, first meets the requirements of section 6015 (a) on January 15, 1956, and the declaration is filed on or before March 15, 1956, the estimated tax shall be paid in 2 equal installments, one at the time of filing of such declaration and the other on or before July 15, 1956.

§ 1.6153–3 Short taxable years.

In the case of a short taxable year of an individual for which a declaration is required to be filed the estimated tax shall be paid in equal installments, one at the time of filing the declaration, one on the 15th day of the 6th month of the taxable year and another on the 15th day of the 9th month of such year unless the short taxable year closed during or prior to such 6th or 9th month, and one on the 15th day of the 1st month of the succeeding taxable year. For example, if the short taxable year is the period of 10 months from January 1, 1955, to October 31, 1955, and the declaration is required to be filed on or before April 15, 1955, the estimated tax is payable in 4 equal installments, one on the date of filing the declaration, and one each on June 15, September 15, and November 15, 1955. If in such case the declaration is required to be filed after April 15 but on or before June 15, the tax will be payable in 3 equal installments, one on the date of filing the declaration, and one each on September 15, and November 15, 1955. The provisions of paragraph (a) (3) of § 1.6153–1, relating to payment of estimated tax in any case in which the declaration is filed after the time prescribed in section 6073 and §§ 1.6073–1 to 1.6073–4, inclusive, are equally applicable to the payment of the estimated tax for short taxable years.

§ 1.6153–4 Extension of time for paying the estimated tax.

An extension of time granted an individual under section 6081 for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. See § 1.6073–4 for rules relating to extensions of time for filing declarations of estimated tax by individuals. An application for an extension of time for paying a particular installment of the estimated tax shall be addressed to the district director for the district in which the taxpayer files his declaration, and must contain a full recital of the causes for the delay. Such extension may be for a reasonable period not to exceed 6 months from the date fixed for payment thereof except in the case of a taxpayer who is abroad. Such extension does not relieve the taxpayer from the addition to the tax imposed by section 6654, and the period of the underpayment will be determined under section 6654(c) without regard to such extension.

§ 1.6154 Statutory provisions; installment payments of estimated income tax by corporations.

SEC. 6154. *Installment payments of estimated income tax by corporations*—(a) *Amount of estimated income tax required to be paid.* The amount of estimated tax (as defined in section 6016 (b)) with respect to which a declaration is required under section 6016 shall be paid as follows:

If the taxable year ends—	The amount required to be paid shall be the following percentage of the estimated tax
On or after December 31, 1955, and before December 31, 1956	10
On or after December 31, 1956, and before December 31, 1957	20
On or after December 31, 1957, and before December 31, 1958	30
On or after December 31, 1958, and before December 31, 1959	40
On or after December 31, 1959	50

(b) *Time for payment of installment.* If the declaration is filed on or before the 15th day of the 9th month of the taxable year, the amount determined under subsection (a) shall be paid in two equal installments. The first installment shall be paid on or before the 15th day of the 9th month of the taxable year, and the second installment shall be paid on or before the 15th day of the 12th month of the taxable year. If the declaration is filed after the 15th day of the 9th month of the taxable year, the amount determined under subsection (a) shall be paid in full on or before the 15th day of the 12th month of the taxable year.

(c) *Amendment of declaration.* If any amendment of a declaration is filed, installments payable on the 15th day of the 12th month, if any, shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease, as the case may be, in the estimated tax by reason of such amendment.

(d) *Application to short taxable year.* The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

(e) *Installments paid in advance.* At the election of the corporation, any installment of the estimated tax may be paid prior to the date prescribed for its payment.

§ 1.6154–1 Payment of estimated tax by corporations.

(a) *Amount required to be paid.* Every corporation required to file a declaration of estimated tax shall pay the following percentage of its estimated tax:

If the taxable year ends—	The amount required to be paid is the following percentage of the estimated tax
On or after December 31, 1955, and before December 31, 1956	10
On or after December 31, 1956, and before December 31, 1957	20
On or after December 31, 1957, and before December 31, 1958	30
On or after December 31, 1958, and before December 31, 1959	40
On or after December 31, 1959	50

(b) *Time for payment.* (1) In the case of a corporation on the calendar year basis which files its declaration on or before September 15 of the taxable year, the percentage of the estimated tax required to be paid is payable in two equal installments, one at the time of filing the declaration, and the other on or before December 15 of the taxable year. If the corporation files its declaration after September 15 of the taxable year, the percentage of the estimated tax required to be paid is payable in full on or before December 15 of the taxable year.

(2) In the case of a corporation whose taxable year is not the calendar year, the dates prescribed for payment of the estimated tax shall be the 15th day of the 9th month and the 15th day of the 12th month of such taxable year. If the corporation files its declaration after the 15th day of such 9th month, the percentage of the estimated tax required to be paid is payable in full on or before the 15th day of such 12th month.

(c) *Amendment of declaration.* In the case of an amended declaration, filed in accordance with section 6074, the installment payable on the 15th day of the 12th month of the taxable year shall be ratably increased or decreased, as the case may be, to reflect the increase or decrease in the estimated tax by reason of the amended declaration. For example, C, a corporation on the calendar year basis filed a declaration on September 15, 1955, reporting an estimated tax in the amount of $20,000. The first installment of $1,000 (5 percent of $20,000) accompanied the declaration. However, C filed an amended declaration on December 15, 1955, showing an estimated tax of $30,000. Since C has already paid $1,000, it must make a payment in the amount of $2,000 computed as follows:

Required amount of estimated tax which must be paid for calendar year 1955 (10% of $30,000)	$3,000
Amount paid with original estimate (5% of $20,000)	1,000
Balance to accompany amended declaration	2,000

Had the amended declaration been filed on December 10, 1955, then only the balance of the first installment ($500) otherwise due on September 15 would have been required to be paid with the declaration and the installment required to be paid on or before December 15, 1955, would be $1,500.

(d) *Installments paid in advance.* A corporation may, at its election, pay any installment of its estimated tax in advance of the due date.

(e) *Credit against income tax.* Payments of estimated tax shall be considered payments on account of the income tax liability for the taxable year. Hence the amount of estimated tax paid shall be entered on the return as a credit to be applied against the tax shown thereon.

§ 1.6154–2 Short taxable years.

(a) *In general.* In the case of a corporation filing a declaration for a short taxable year the amount of the estimated tax required to be paid shall be paid as follows:

(1) If the short taxable year is a period of more than 9 months and the declaration is required to be filed on or before the 15th day of the 9th month, the amount of the estimated tax required to be paid shall be paid in 2 installments; the 1st on or before the 15th day of the 9th month and the 2d on or before the 15th day of the last month of the short taxable year.

(2) If the short taxable year is a period of 9 or more months and the declaration is not required to be filed until the 15th day of the last month of the short taxable year, the amount of the estimated tax required to be paid shall be paid in full on or before the 15th day of the last month of the short taxable year.

(b) *Examples.* The application of the provisions of this section may be illustrated by the following examples:

Example (1). If a corporation changes from a calendar year to a fiscal year beginning November 1, 1956, and ending October 31, 1957, a declaration is required on or before September 15, 1956, for the short taxable year January 1, 1956 to October 31, 1956, if such corporation otherwise meets the requirements of section 6016 (a) on or before August 31, 1956. In such case the first installment of the estimated tax must be paid with the declaration filed on September 15, 1956. The second installment must be paid on or before October 15, 1956, the 15th day of the last month in the short taxable year.

Example (2). If, in the first example, the corporation did not meet the requirements of section 6016 (a) until after August 31, 1956, but before October 1, 1956, the declaration would have been due on October 15, 1956. In such case the amount of the estimated tax required to be paid must be paid in full with the declaration filed on October 15, 1956.

§ 1.6154–3 Extension of time for paying estimated tax.

An extension of time granted a corporation under section 6081 for filing the declaration of estimated tax automatically extends the time for paying the estimated tax (without interest) for the same period. See § 1.6074–3 for rules relating to extensions of time for filing declarations of estimated tax by corporations. An application for an extension of time for paying an installment of the estimated tax shall be addressed to the district director for the district in which the taxpayer files its declaration, and must contain a full recital of the causes for the delay. Any such extension will not relieve the taxpayer from the addition to the tax imposed by section 6655, and the period of the underpayment will be determined under section 6655 (c) without regard to such extension.

EXTENSIONS OF TIME FOR PAYMENT

§ 1.6161 Statutory provisions; extension of time for paying tax.

SEC. 6161. *Extension of time for paying tax*—(a) *Amount determined by taxpayer on return*—(1) *General rule.* The Secretary or his delegate, except as otherwise provided in this title, may extend the time for payment of the amount of the tax shown, or required to be shown, on any return or declaration required under authority of this title (or any installment thereof), for a reasonable period not to exceed 6 months from the date fixed for payment thereof. Such extension may exceed 6 months in the case of a taxpayer who is abroad.

* * * * * *

(b) *Amount determined as deficiency.* Under regulations prescribed by the Secretary or his delegate, the Secretary or his delegate may extend, to the extent provided below,

the time for payment of the amount determined as a deficiency:

(1) In the case of a tax imposed by chapter 1 or 12, for a period not to exceed 18 months from the date fixed for payment of the deficiency, and, in exceptional cases, for a further period not to exceed 12 months;

* * * * *

An extension under this subsection may be granted only where it is shown to the satisfaction of the Secretary or his delegate that the payment of a deficiency upon the date fixed for the payment thereof will result in undue hardship to the taxpayer in the case of a tax imposed by chapter 1, to the estate in the case of a tax imposed by chapter 11, or to the donor in the case of a tax imposed by chapter 12. No extension shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

* * * * *

§ 1.6161–1 Extension of time for paying tax or deficiency.

(a) *In general*—(1) *Tax shown or required to be shown on return.* A reasonable extension of the time for payment of the amount of any tax imposed by subtitle A of the Code and shown or required to be shown on any return, or for payment of the amount of any installment of such tax, may be granted by the district directors (including the Director of International Operations) at the request of the taxpayer. The period of such extension shall not be in excess of six months from the date fixed for payment of such tax or installment, except that if the taxpayer is abroad the period of the extension may be in excess of six months.

(2) *Deficiency.* The time for payment of any amount determined as a deficiency in respect of tax imposed by chapter 1 of the Code, or for the payment of any part thereof, may, at the request of the taxpayer, be extended by the internal revenue officer to whom the tax is required to be paid for a period not to exceed 18 months from the date fixed for payment of the deficiency, as shown on the notice and demand, and, in exceptional cases, for a further period not in excess of 12 months. No extension of the time for payment of a deficiency shall be granted if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(3) *Extension of time for filing distinguished.* The granting of an extension of time for filing a return does not operate to extend the time for the payment of the tax or any part thereof, unless so specified in the extension.

(b) *Undue hardship required for extension.* An extension of the time for payment shall be granted only upon a satisfactory showing that payment on the due date of the amount with respect to which the extension is desired will result in an undue hardship. The extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss, for example, loss due to the sale of property at a sacrifice price, will result to the taxpayer from making payment on the due date of the amount with respect to which the extension is desired. If a market exists, the sale of property at the current market price is not ordinarily considered as resulting in an undue hardship.

(c) *Application for extension.* An application for an extension of the time for payment of the tax shown or required to be shown on any return, or for the payment of any installment thereof, or for the payment of any amount determined as a deficiency shall be made on Form 1127 and shall be accompanied by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. Such application shall also be accompanied by a statement of the assets and liabilities of the taxpayer and an itemized statement showing all receipts and disbursements for each of the three months immediately preceding the due date of the amount to which the application relates. The application, with supporting documents, must be filed with the internal revenue officer to whom the tax is required to be paid on or before the date prescribed for payment of the amount with respect to which the extension is desired. The application will be examined, and within 30 days, if possible, will be denied, granted, or tentatively granted subject to certain conditions of which the taxpayer will be notified. If an additional extension is desired, the request therefor must be made on or before the expiration of the period for which the prior extension is granted.

(d) *Payment pursuant to extension.* If an extension of time for payment is granted, the amount the time for payment of which is so extended shall be paid on or before the expiration of the period of the extension without the necessity of notice and demand. The granting of an extension of the time for payment of the tax or deficiency does not relieve the taxpayer from liability for the payment of interest thereon during the period of the extension. See section 6601 and § 301.6601–1 of this chapter (Regulations on Procedure and Administration). Further, the granting of an extension of the time for payment of one installment of the tax does not extend the time for payment of subsequent installments.

(e) *Cross reference.* For extensions of time for payment of estimated tax, see §§ 1.6073–4 and 1.6074–3.

§ 1.6162 Statutory provisions; extension of time for payment of tax on gain attributable to liquidation of personal holding companies.

SEC. 6162. *Extension of time for payment of tax on gain attributable to liquidation of personal holding companies*—(a) *Extension permitted.* The Secretary or his delegate may (under regulations prescribed by the Secretary or his delegate) extend (for a period not to exceed 5 years from the date fixed for the payment of the tax) the time for the payment of such portion of the amount determined as the tax under chapter 1 by the taxpayer for any taxable year beginning before January 1, 1956, as is attributable to the short-term or long-term capital gain derived by the taxpayer from the receipt by him of property other than money on a complete liquidation of a corporation to which section 331(a)(1) or 342 applies. This section shall apply only if the corporation, for its taxable year preceding the year in which occurred the complete liquidation (or the first of the series of distributions in complete liquidation), was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company. An extension under this section shall be granted only if it is shown to the satisfaction of the Secretary or his delegate that the failure to grant the extension will result in undue hardship to the taxpayer.

(b) *Security.* For authority of the Secretary or his delegate to require security in the case of such an extension, see section 6165.

§ 1.6162–1 Extension of time for payment of tax on gain attributable to liquidation of personal holding companies.

(a) *In general.* (1) If it is shown to the satisfaction of the district director that undue hardship to the taxpayer will result from the payment of such portion of the amount determined as the tax under chapter 1 of the Code by the taxpayer as is attributable to the short-term or long-term capital gain derived by the taxpayer from the receipt by him of property other than money on a complete liquidation of a corporation to which section 331(a)(1) or 342 applies, the district director may grant an extension of time for the payment of such portion of the tax. For the meaning of the term "undue hardship", see paragraph (b) of § 1.6161–1.

(2) The extension of time for payment shall be for a period not in excess of five years. The extension shall only be granted for a taxable year beginning before January 1, 1956, and shall apply only if the corporation, for its taxable year preceding the year in which occurred the complete liquidation (or the first of the series of distributions in complete liquidation), was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company.

(b) *Requirement of bond.* As a condition to the granting of an extension of time for payment, the taxpayer will usually be required by the district director to furnish a bond as provided in section 6165 and the regulations thereunder. For other provisions with respect to bonds, see section 7101 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

§ 1.6164 Statutory provisions; extension of time for payment of taxes by corporations expecting carrybacks.

SEC. 6164. *Extension of time for payment of taxes by corporations expecting carrybacks*—(a) *In general.* If a corporation, in any taxable year, files with the Secretary or his delegate a statement, as provided in subsection (b), with respect to an expected net operating loss carryback from such taxable year, the time for payment of all or part of any tax imposed by subtitle A for the taxable year immediately preceding such taxable year shall be extended, to the extent and subject to the conditions and limitations hereinafter provided in this section.

(b) *Contents of statement.* The statement shall be filed at such time and in such manner and form as the Secretary or his delegate may by regulations prescribe. Such statement shall set forth that the corporation expects to have a net operating loss carryback, as provided in section 172(b), from the taxable year in which such statement is made, and shall set forth, in such

detail and with such supporting data and explanation as such regulations shall require—

(1) The estimated amount of the expected net operating loss;

(2) The reasons, facts, and circumstances which cause the corporation to expect such net operating loss;

(3) The amount of the reduction of the tax previously determined attributable to the expected carryback, such tax previously determined being ascertained in accordance with the method prescribed in section 1314 (a); and such reduction being determined by applying the expected carryback in the manner provided by law to the items on the basis of which such tax was determined;

(4) The tax and the part thereof the time for payment of which is to be extended; and

(5) Such other information for purposes of carrying out the provisions of this section as may be required by such regulations.

The Secretary or his delegate shall, upon request, furnish a receipt for any statement filed, which shall set forth the date of such filing.

(c) *Amount to which extension relates and installment payments.* The amount the time for payment of which may be extended under subsection (a) with respect to any tax shall not exceed the amount of such tax shown on the return, increased by any amount assessed as a deficiency (or as interest or addition to the tax) prior to the date of filing the statement and decreased by any amount paid or required to be paid prior to the date of such filing, and the total amount of the tax the time for payment of which may be extended shall not exceed the amount stated under subsection (b) (3). For purposes of this subsection, an amount shall not be considered as required to be paid unless shown on the return or assessed as a deficiency (or as interest or addition to the tax), and an amount assessed as a deficiency (or as interest or addition to the tax) shall be considered to be required to be paid prior to the date of filing of the statement if the 10th day after notice and demand for its payment occurs prior to such date. If an extension of time under this section relates to only a part of the tax, the time for payment of the remainder shall be considered to be the dates on which payments would have been required if such remainder had been the tax and the taxpayer had elected to pay the tax in installments as provided in section 6152.

(d) *Period of extension.* The extension of time for payment provided in this section shall expire—

(1) On the last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for the filing of the return for the taxable year of the expected net operating loss, or

(2) If an application for tentative carryback adjustment provided in section 6411 with respect to such loss is filed before the expiration of the period prescribed in paragraph (1), on the date on which notice is mailed by certified mail or registered mail by the Secretary or his delegate to the taxpayer that such application is allowed or disallowed in whole or in part.

(e) *Revised statements.* Each statement filed under subsection (a) with respect to any taxable year shall be in lieu of the last statement previously filed with respect to such year. If the amount the time for payment of which is extended under a statement filed is less than the amount under the last statement previously filed, the extension of time shall be terminated as to the difference between the two amounts.

(f) *Termination.* The Secretary or his delegate is not required to make any examination of the statement, but he may make such examination thereof as he deems necessary and practicable. The Secretary or his delegate shall terminate the extension as to any part of the amount to which it relates which he deems should be terminated because, upon such examination, he believes that, as of the time such examination is made, all or any part of the statement clearly is in a material respect erroneous or unreasonable.

(g) *Payments on termination.* If an extension of time is terminated under subsection (e) or (f) with respect to any amount, then—

(1) No further extension of time shall be made under this section with respect to such amount, and

(2) The time for payment of such amount shall be considered to be the dates on which payments would have been required if there had been no extension with respect to such amount and the taxpayer had elected to pay the tax in installments as provided in section 6152.

(h) *Jeopardy.* If the Secretary or his delegate believes that collection of the amount to which an extension under this section relates is in jeopardy, he shall immediately terminate such extension, and notice and demand shall be made by him for payment of such amount.

(i) *Consolidated returns.* If the corporation seeking an extension of time under this section made or was required to make a consolidated return, either for the taxable year within which the net operating loss arises or for the preceding taxable year affected by such loss, the provisions of such section shall apply only to such extent and subject to such conditions, limitations, and exceptions as the Secretary or his delegate may by regulations prescribe.

[Sec. 6164 as amended by sec. 89(b), Technical Amendments Act 1958 (72 Stat. 1565)]

§ 1.6164–1 Extensions of time for payment of taxes by corporations expecting carrybacks.

(a) *In general.* If a corporation in any taxable year files a statement with respect to an expected net operating loss carryback from such taxable year, such corporation may extend the time for the payment of all or part of any tax imposed by subtitle A of the Code for the taxable year immediately preceding such taxable year to the extent and subject to the limitations provided in section 6164. A corporation may extend the time for payment with respect to only such taxes as meet the following requirements:

(1) The tax must be one imposed by subtitle A of the Code;

(2) The tax must be for the taxable year immediately preceding the taxable year of the expected net operating loss;

(3) The tax must be shown on the return or must be assessed within the taxable year of the expected net operating loss; and

(4) The tax must not have been paid or required to have been paid prior to the filing of the statement.

(b) *Statement for purpose of extending time for payment.* (1) The time for payment of the tax is automatically extended upon the filing of a statement on Form 1138 by the corporation with the district director for the district where the tax is payable. The statement on Form 1138 must be filled out in accordance with the instructions accompanying the form, and all information required by the form and the instructions must be furnished by the taxpayer. The district director, upon request, will furnish a receipt for any statement filed. Such receipt will show the date the statement was filed.

(2) The period of extension is that provided in section 6164 (d) and § 1.6164–5 unless sooner terminated by action of either the district director or the corporation.

§ 1.6164–2 Amount of tax the time for payment of which may be extended.

(a) *Total amount to which extension may relate.* The total amount of tax the time for payment of which may be extended under section 6164 may not exceed the amount of the reduction of the taxes previously determined attributable to the expected carryback.

(b) *Amount of tax to which extension may relate.* (1) The taxpayer shall specify on Form 1138 the kind of tax and the amount thereof the time for payment of which is to be extended. The amount of tax to which an extension may relate shall not exceed the amount of such tax shown on the return as filed, increased by any amount assessed as a deficiency (or as interest or addition to the tax) prior to the date of filing the statement and decreased by any amount paid or required to be paid prior to such date. In determining the amount of tax required to be paid prior to the date of filing the statement, only the following amounts shall be taken into consideration:

(i) The amount of the tax shown on the return as filed; and

(ii) Any amount assessed as a deficiency (or as interest or addition to the tax) if the tenth day after notice and demand for its payment occurs prior to the date of the filing of the statement.

(2) Delinquent installments are to be considered amounts required to be paid prior to the date of filing the statement. In the case of any authorized extension of time under sections 6161 and 6162, the amount of tax the time for payment of which is so extended is not to be considered required to be paid prior to the end of such extension. Similarly, any amount assessed as a deficiency (or as interest or addition to the tax) is not to be considered required to be paid prior to the date of the filing of the statement unless the tenth day after notice and demand for its payment falls prior to the date of the filing of the statement.

(3) The taxpayer may choose to extend the time for payment of all of one or more taxes, or it may choose to extend the time for payment of portions of several taxes. The taxes chosen by the taxpayer need not be those taxes which are affected by the carryback.

§ 1.6164–3 Computation of the amount of reduction of the tax previously determined.

(a) *Tax previously determined.* The taxpayer is to determine the amount of the reduction, attributable to the expected carryback, in the aggregate of the taxes previously determined for taxable years prior to the taxable year of the expected net operating loss. The tax previously determined is to be ascertained in

accordance with the method prescribed in section 1314(a). Thus, the tax previously determined will be the tax shown on the return as filed, increased by any amounts assessed (or collected without assessment) as deficiencies prior to the date of the filing of the statement, and decreased by any amounts abated, credited, refunded, or otherwise repaid prior to such date. Any items as to which the Internal Revenue Service and the taxpayer are in disagreement at the time of the filing of the statement shall be taken into account in ascertaining the tax previously determined only if, and to the extent that, they were reported in the return, or were reflected in any amounts assessed (or collected without assessment) as deficiencies, or in any amounts abated, credited, refunded, or otherwise repaid, prior to the date of the filing of the statement. The tax previously determined will reflect the foreign tax credit and the credit for tax withheld at source provided in section 32.

(b) *Reduction attributable to the expected carryback.* The reduction, attributable to the expected carryback or related adjustments, in any tax previously determined is to be ascertained by applying the expected carryback as if it were a determined net operating loss carryback, in accordance with the provisions of section 172 and §§ 1.172–1 to 1.172–8, inclusive. Items must be taken into account only to the extent that such items were included in the return, or were reflected in amounts assessed (or collected without assessment) as deficiencies, or in amounts abated, credited, refunded, or otherwise repaid, prior to the date of the filing of the statement. Thus, for example, if the taxpayer claims a deduction for depreciation of $10,000 in its return and the Internal Revenue Service asserts that only $4,000 is properly deductible, no change is to be made in the $10,000 depreciation deduction as shown by the taxpayer on his return unless a deficiency has been assessed, or an amount collected without assessment, prior to the date of filing of the statement as a result of a change in the depreciation deduction, or unless such change in the depreciation deduction was reflected in an amount abated, credited, refunded, or otherwise repaid prior to such date.

§ 1.6164–4 Payment of remainder of tax where extension relates to only part of the tax.

(a) *Time for payment.* If an extension of time relates to only part of the tax, the time for payment of the remainder of the tax shall be considered to be the dates on which payments would have been required if such remainder had been the tax and the taxpayer had elected to pay the tax in installments as provided in section 6152(a).

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example. Corporation X, which keeps its books and makes its tax returns on the calendar year basis, filed its income tax return for 1956 on March 15, 1957. The corporation showed a tax of $1,000 on its return and paid 50 percent of such tax, or $500 on March 15, 1957. On June 3, 1957, Corporation X, pursuant to the provisions of section 6164, extended the time for payment of $400 of such tax. The remainder of the tax the time for payment of which was not so extended, i. e., $600, is to be considered the tax for purposes of determining when it is to be paid. The remainder is considered to be due on the dates on which payment would have been required if such remainder had been the tax. Since the taxable year ended on December 31, 1956, the tax is payable in two equal installments of $300 each on March 15, 1957, and June 17, 1957. The taxpayer, having paid $500 on March 15, 1957, will have $100 to pay on June 17, 1957.

§ 1.6164–5 Period of extension.

If the time for the payment of any tax has been extended pursuant to section 6164, such extension shall expire:

(a) On the last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for the filing of the return for the taxable year of the expected net operating loss; or

(b) If an application for a tentative carryback adjustment provided in section 6411 with respect to such loss is filed before the expiration of the period specified in paragraph (a) of this section, on the date on which notice is mailed by registered mail prior to September 3, 1958, and by either registered or certified mail on and after September 3, 1958, to the taxpayer that such application is allowed or disallowed in whole or in part.

§ 1.6164–6 Revised statements.

(a) *Requirements and effect.* A corporation may file more than one statement under section 6164 with respect to any one taxable year. Each statement is to be considered a new statement and not an amendment of any prior statement. Each such new statement is to be in lieu of the last statement previously filed with respect to the taxable year. The new statement may extend the time for payment of a greater or lesser amount of tax than was extended under the prior statement or may change the kind of tax the time for payment of which is to be extended. The extension may not relate to any amount of tax which was paid or required to be paid prior to the date of filing the new statement. Any amount of tax the time for payment of which was extended under a prior statement, however, may continue to be extended under the new statement. If the amount the time for payment of which is extended under the new statement is less than the amount so extended under the last statement previously filed, the extension of time shall be terminated on the date the new statement is filed as to the difference between the two amounts. See § 1.6164–8 for the dates on which such difference must be paid. If a corporation pays any amount of tax, the time for payment of which was extended, prior to the date the extension would otherwise terminate, the extension with respect to such amount shall be deemed terminated, without regard to whether a new statement is filed, on the date such amount is paid. The corporation shall indicate on each new statement filed that it has already filed one or more prior statements with respect to the taxable year. The corporation shall likewise indicate the date each prior statement was filed and the amount of each tax the time for payment of which was extended under each prior statement.

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example. Corporation Y, which keeps its books and makes its tax returns on the calendar year basis, filed its income tax return for 1956 on March 15, 1957, showing a tax of $100,000. At the same time it filed a statement under section 6164 in which it stated that it expected to have a net operating loss of $75,000 in 1957 and that the reduction in the tax previously determined for 1955 (the second taxable year preceding the year of the expected net operating loss) attributable to the expected net operating loss carryback resulting from such expected loss, would be $39,000. The corporation accordingly extended the time for payment of $39,000 of its income tax for 1956, and paid $30,500 (50 percent of the excess of $100,000 over $39,000) of such tax on March 15, 1957 (see section 6164(c) and § 1.6164–4). As a result of its operations during the next several months, the corporation filed a second statement on June 3, 1957, in which it stated that its expected net operating loss for 1957 would amount to $150,000 and that the corresponding reduction in the tax for 1955 would amount to $78,000. Corporation Y under the new statement may extend the time for payment of $30,500, the installment due on June 17, 1957, and the time for payment of the $39,000 extended under the first statement filed on March 15, 1957, may continue to be extended under the second statement. The $30,500 which was paid on March 15, 1957, will not be affected by the second statement filed on June 3, 1957.

§ 1.6164–7 Termination by district director.

(a) *After an examination of the statement filed by the corporation is made.* The district director is authorized to make such examination of the statements filed as he deems necessary and practicable. If, upon such examination as he may make, the district director believes that, as of the time he makes the examination, all or any part of the statement is in a material respect erroneous or unreasonable, he will terminate the extension as to any part of the amount to which such extension relates which he deems should be terminated.

(b) *Jeopardy.* If the district director believes that the collection of any amount to which an extension under section 6164 relates is in jeopardy, he will immediately terminate the extension. In the case of such a termination, notice and demand shall be made by the district director for payment of such amount, and there may be no further extension of time under section 6164 with respect to such amount.

§ 1.6164–8 Payments on termination.

(a) *In general.* If an extension of time under section 6164 is terminated with respect to any amount either (1) by the filing of a new statement by the taxpayer under section 6164(e) extending

the time for payment of a lesser amount than was extended in a prior statement, or (2) by action of the district director under section 6164(f) after making an examination of the statement filed by the corporation, no further extension of time may be made under section 6164 with respect to such amount. The time for payment of such amount shall be the dates on which payments would have been required if there had been no extension with respect to such amount and the taxpayer had elected under section 6152(a) to pay the tax in installments.

(b) *Example.* The provisions of this section may be illustrated by the following example:

Example. Corporation Z, which keeps its books and makes its tax returns on the calendar year basis, filed its income tax return for 1956 on March 15, 1957, showing a tax of $100,000. At the same time it filed a statement under section 6164 extending the time for payment of the entire $100,000 on the basis of an expected net operating loss carryback from 1957. On April 10, 1957, the corporation filed a new statement indicating that the reduction, attributable to the carryback from 1957, in its income tax for 1956, would only be $80,000, and thus terminated the above extension of $20,000. The time for payment of such $20,000 may not be extended again, and such $20,000 is payable as if it were the tax for 1956 and Corporation Z had elected to pay such tax in installments. That is, $10,000 is payable on March 15, 1957, and $10,000 payable on June 17, 1957. Inasmuch as the March 15 date had already passed when the Corporation Z terminated the extension with respect to the $20,000, $10,000 is payable immediately upon such termination, and the other installment of $10,000 is payable on June 17, 1957. This example would also apply if the extension of time for payment of the $20,000 were terminated instead by the district director on April 10, 1957.

§ 1.6164–9 Cross references.

For provisions with respect to interest due on amounts the payment of which is extended under section 6164, see section 6601 and paragraph (e) of § 301.6601–1 of this chapter (Regulations on Procedure and Administration). For provisions relating to the applicability of section 6164 in the case of corporations making or required to make consolidated returns, see § 1.1502–19.

§ 1.6165 Statutory provisions; bonds where time to pay tax or deficiency has been extended.

SEC. 6165. *Bonds where time to pay tax or deficiency has been extended.* In the event the Secretary or his delegate grants any extension of time within which to pay any tax or any deficiency therein, the Secretary or his delegate may require the taxpayer to furnish a bond in such amount (not exceeding double the amount with respect to which the extension is granted) conditioned upon the payment of the amount extended in accordance with the terms of such extension.

§ 1.6165–1 Bonds where time to pay the tax or deficiency has been extended.

The district director, including the Director of International Operations, may, as a condition to the granting of an extension of time within which to pay any tax or any deficiency therein, require the taxpayer to furnish a bond in an amount not exceeding double the amount of the tax with respect to which the extension is granted. Such bond shall be furnished in accordance with the provisions contained in section 7101 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration).

ABATEMENTS, CREDITS, AND REFUNDS

§ 1.6411 Statutory provisions; tentative carryback adjustments.

SEC. 6411. *Tentative carryback adjustments*—(a) *Application for adjustment.* A taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by a net operating loss carryback, provided in section 172(b), from any taxable year. The application shall be verified in the manner prescribed by section 6065 in the case of a return of such taxpayer, and shall be filed, on or after the date of filing of the return for the taxable year of the net operating loss from which the carryback results and within a period of 12 months from the end of such taxable year, in the manner and form required by regulations prescribed by the Secretary or his delegate. The application shall set forth in such detail and with such supporting data and explanation as such regulations shall require—

(1) The amount of the net operating loss;

(2) The amount of the tax previously determined for the prior taxable year affected by such carryback, the tax previously determined being ascertained in accordance with the method prescribed in section 1314(a);

(3) The amount of decrease in such tax, attributable to such carryback, such decrease being determined by applying the carryback in the manner provided by law to the items on the basis of which such tax was determined;

(4) The unpaid amount of such tax, not including any amount required to be shown under paragraph (5);

(5) The amount, with respect to the tax for the taxable year immediately preceding the taxable year of such loss, as to which an extension of time for payment under section 6164 is in effect; and

(6) Such other information for purposes of carrying out the provisions of this section as may be required by such regulations.

An application under this subsection shall not constitute a claim for credit or refund.

(b) *Allowance of adjustments.* Within a period of 90 days from the date on which an application for a tentative carryback adjustment is filed under subsection (a), or from the last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for filing the return for the taxable year of the net operating loss from which such carryback results, whichever is the later, the Secretary or his delegate shall make, to the extent he deems practicable in such period, a limited examination of the application, to discover omissions and errors of computation therein, and shall determine the amount of the decrease in the tax attributable to such carryback upon the basis of the application and the examination, except that the Secretary or his delegate may disallow, without further action, any application which he finds contains errors of computation which he deems cannot be corrected by him within such 90-day period or material omissions. Such decrease shall be applied against any unpaid amount of the tax decreased (including any amount of such tax as to which an extension of time under section 6164 is in effect) and any remainder shall be credited against any unsatisfied amount of any tax for the taxable year immediately preceding the taxable year of the net operating loss the time for payment of which tax is extended under section 6164. Any remainder shall, within such 90-day period, be either credited against any tax or installment thereof then due from the taxpayer, or refunded to the taxpayer.

(c) *Consolidated returns.* If the corporation seeking a tentative carryback adjustment under this section, made or was required to make a consolidated return, either for the taxable year within which the net operating loss arises, or for the preceding taxable year affected by such loss, the provisions of this section shall apply only to such extent and subject to such conditions, limitations, and exceptions as the Secretary or his delegate may by regulations prescribe.

§ 1.6411–1 Tentative carryback adjustments.

(a) *In general.* Any taxpayer who has a net operating loss under section 172 may file an application under section 6411 for a tentative carryback adjustment of the taxes for taxable years prior to the taxable year of the loss which are affected by the net operating loss carryback resulting from such loss. The right to file an application for a tentative carryback adjustment is not limited to corporations, but is available to any taxpayer. A corporation may file an application for a tentative carryback adjustment even though it has not extended the time for payment of tax under section 6164.

(b) *Contents of application.* (1) The application for a tentative carryback adjustment shall be filed, in the case of a corporation, on Form 1139, and in the case of taxpayers other than corporations, on Form 1045. The application shall be filled out in accordance with the instructions accompanying the form, and all information required by the form and the instructions must be furnished by the taxpayer.

(2) An application for a tentative carryback adjustment does not constitute a claim for credit or refund. If such application is disallowed by the district director in whole or in part, no suit may be maintained in any court for the recovery of any tax based on such application. The filing of an application for a tentative carryback adjustment will not constitute the filing of a claim for credit or refund within the meaning of section 6511 for purposes of determining whether a claim for credit or refund was filed prior to the expiration of the applicable period of limitation. The taxpayer, however, may file a claim for credit or refund under section 6402 at any time prior to the expiration of the applicable period of limitation, and may maintain a suit based on such claim if it is disallowed or if the district director does not act on the claim within six months from the date it is filed. Such claim may be filed before, simultaneously with, or after the filing of the application for a tentative carryback adjustment. A claim for credit or refund under section 6402 filed after the filing of an application for a tentative carryback adjustment is not to be considered an amendment of such

application. Such claim, however, in proper cases may constitute an amendment to a prior claim filed under section 6402.

(c) *Time and place for filing application.* The application for a tentative carryback adjustment shall be filed on or after the date of the filing of the return for the taxable year of the net operating loss and shall be filed within a period of twelve months from the end of such taxable year. Any application filed prior to the date the return for the taxable year of the loss is filed shall be considered to have been filed on the date such return is filed. The application shall be filed with the district director for the internal revenue district in which the tax was paid or the assessment was made.

§ 1.6411–2 Computation of tentative carryback adjustment.

(a) *Tax previously determined.* The taxpayer is to determine the amount of decrease, attributable to the carryback, in tax previously determined for each taxable year before the taxable year of the net operating loss. The tax previously determined is to be ascertained in accordance with the method prescribed in section 1314(a). Thus, the tax previously determined will be the tax shown on the return as filed, increased by any amounts assessed (or collected without assessment) as deficiencies before the date of the filing of the application for a tentative carryback adjustment, and decreased by any amounts abated, credited, refunded, or otherwise repaid prior to such date. Any items as to which the Internal Revenue Service and the taxpayer are in disagreement at the time of the filing of the application shall be taken into account in ascertaining the tax previously determined only if, and to the extent that, they were reported in the return, or were reflected in any amounts assessed (or collected without assessment) as deficiencies, or in any amounts abated, credited, refunded, or otherwise repaid, before the date of filing the application. The tax previously determined, therefore, will reflect the foreign tax credit and the credit for tax withheld at source provided in section 32.

(b) *Decrease attributable to carryback.* The decrease in tax previously determined which is affected by the carryback or any related adjustments, is to be determined, except for such carryback and related adjustments, on the basis of the items which entered into the computation of such tax as previously determined; the tax previously determined being ascertained in the manner described in this section. In determining any such decrease, items shall be taken into account only to the extent that they were reported in the return, or were reflected in amounts assessed (or collected without assessment) as deficiencies, or in amounts abated, credited, refunded, or otherwise repaid, before the date of filing the application for a tentative carryback adjustment. If the Internal Revenue Service and the taxpayer are in disagreement as to the proper treatment of any item, it shall be assumed for purposes of determining the decrease in the tax previously determined that such item was correctly reported by the taxpayer unless, and to the extent that, the disagreement has resulted in the assessment of a deficiency (or the collection of an amount without an assessment), or the allowing or making of an abatement, credit, refund, or other repayment, before the date of filing the application. Thus, if the taxpayer claimed a deduction on its return of $50,000 for salaries paid its officers but the district director asserts that such deduction should not exceed $20,000, and the Internal Revenue Service and the taxpayer have not agreed on the amount properly deductible before the date the application for a tentative carryback adjustment is filed, $50,000 shall be considered as the amount properly deductible for purposes of determining the decrease in tax previously determined in respect of the application for a tentative carryback adjustment. In determining the decrease in tax previously determined, any items which are affected by the carryback must be adjusted to reflect such carryback. Thus, unless otherwise provided, any deduction limited, for example, by adjusted gross income, such as the deduction for medical, dental, etc., expenses is to be recomputed on the basis of the adjusted gross income as affected by the carryback.

§ 1.6411–3 Allowance of adjustments.

(a) *Time prescribed.* The district director shall act upon any application for a tentative carryback adjustment filed under section 6411(a) within a period of 90 days from whichever of the following two dates is the later:

(1) The date the application is filed; or

(2) The last day of the month in which falls the last date prescribed by law (including any extension of time granted the taxpayer) for filing the return for the taxable year of the net operating loss from which the carryback results.

(b) *Examination.* Within the 90-day period described in paragraph (a) of this section, the district director shall make, to the extent he deems practicable in such period, an examination of the application to discover omissions and errors of computation. He shall determine within such period the decrease in tax previously determined, affected by the carryback or any related adjustments, upon the basis of the application and such examination. Such decrease shall be determined in the same manner as that provided in section 1314(a) for the determination by the taxpayer of the decrease in taxes previously determined which must be set forth in the application for a tentative carryback adjustment. The district director, however, may correct any errors of computation or omissions he may discover upon examination of the application. In determining the decrease in tax previously determined which is affected by the carryback or any related adjustment, he accordingly may correct any mathematical error appearing on the application and he may likewise correct any modification required by the law and incorrectly made by the taxpayer in computing its net operating loss, the resulting carrybacks, or its net operating loss deduction. If the required modification has not been made by the taxpayer and the district director has available the necessary information to make such modification within the 90-day period, he may, in his discretion, make such modification. In determining such decrease, however, the district director will not, for example, change the amount claimed on the return as a deduction for depreciation because he believes that the taxpayer has claimed an excessive amount; likewise, he will not include in gross income any amount not so included by the taxpayer, even though the district director believes that such amount is subject to tax and properly should be included in gross income.

(c) *Disallowance in whole or in part.* If the district director finds that an application for a tentative carryback adjustment contains material omissions or errors of computation, he may disallow such application in whole or in part without further action. If, however, he deems that any error of computation can be corrected by him within the 90-day period, he may do so and allow the application in whole or in part. The district director's determination as to whether he can correct any error of computation within the 90-day period shall be conclusive. Similarly, his action in disallowing, in whole or in part, any application for a tentative carryback adjustment shall be final and may not be challenged in any proceeding. The taxpayer in such case, however, may file a claim for credit or refund under section 6402, and may maintain a suit based on such claim if it is disallowed or if the district director does not act upon the claim within six months from the date it is filed.

(d) *Application of decrease.* (1) Each decrease determined by the district director in any previously determined tax which is affected by the carryback or any related adjustments shall first be applied against any unpaid amount of the tax with respect to which such decrease was determined. Such unpaid amount of tax may include one or more of the following:

(i) An amount with respect to which the taxpayer is delinquent;

(ii) An amount the time for payment of which has been extended under section 6164 and which is due and payable on or after the date of the allowance of the decrease; and

(iii) An amount (including an amount the time for payment of which has been extended under section 6161 or 6162, but not including an amount the time for payment of which has been extended under section 6164) which is due and payable on or after the date of the allowance of the decrease.

(2) In case the unpaid amount of tax includes more than one of such amounts, the district director, in his discretion, shall determine against which amount or amounts, and in what proportion, the decrease is to be applied. In general, however, the decrease will be applied

against any amounts described in subparagraph (1) (i), (ii), and (iii) of this paragraph in the order named. If there are several amounts of the type described in subparagraph (1) (iii) of this paragraph, any amount of the decrease which is to be applied against such amounts will be applied by assuming that the tax previously determined minus the amount of the decrease to be so applied is "the tax" and that the taxpayer had elected to pay such tax in installments. The unpaid amount of tax against which a decrease may be applied under subparagraph (1) of this paragraph may not include any amount of tax for any taxable year other than the year of the decrease. After making such application, the district director will credit any remainder of the decrease against any unsatisfied amount of any tax for the taxable year immediately preceding the taxable year of the net operating loss the time for payment of which has been extended under section 6164.

(3) Any remainder of the decrease after such application and credits may, within the 90-day period, in the discretion of the district director, be credited against any tax or installment thereof then due from the taxpayer, and, if not so credited, shall be refunded to the taxpayer within such 90-day period.

§ 1.6411–4 Consolidated returns.

For further rules applicable to affiliated groups in the case of tentative carryback adjustments, see § 1.1502–19.

ADDITIONS TO THE TAX, ADDITIONAL AMOUNTS, AND ASSESSABLE PENALTIES

§ 1.6654 Statutory provisions; failure by individual to pay estimated income tax.

SEC. 6654. *Failure by individual to pay estimated income tax*—(a) *Addition to the tax.* In the case of any underpayment of estimated tax by an individual, except as provided in subsection (d), there shall be added to the tax under chapter 1 for the taxable year an amount determined at the rate of 6 percent per annum upon the amount of the underpayment (determined under subsection (b)) for the period of the underpayment (determined under subsection (c)).

(b) *Amount of underpayment.* For purposes of subsection (a), the amount of the underpayment shall be the excess of—

(1) The amount of the installment which would be required to be paid if the estimated [illegible] to 70 percent (66⅔ percent in the case of individuals referred to in section 6073 (b), relating to income from farming) of the tax shown on the return for the taxable year or, if no return was filed, 70 percent (66⅔ percent in the case of individuals referred to in section 6073 (b) relating to income from farming) of the tax for such year, over

(2) The amount, if any, of the installment paid on or before the last date prescribed for such payment.

(c) *Period of underpayment.* The period of the underpayment shall run from the date the installment was required to be paid to whichever of the following dates is the earlier—

(1) The 15th day of the fourth month following the close of the taxable year.

(2) With respect to any portion of the underpayment, the date on which such portion is paid. For purposes of this paragraph, a payment of estimated tax on any installment date shall be considered a payment of any previous underpayment only to the extent such payment exceeds the amount of the installment determined under subsection (b) (1) for such installment date.

(d) *Exception.* Notwithstanding the provisions of the preceding subsections, the addition to the tax with respect to any underpayment of any installment shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceeds whichever of the following is the lesser—

(1) The amount which would have been required to be paid on or before such date if the estimated tax were whichever of the following is the least—

(A) The tax shown on the return of the individual for the preceding taxable year, if a return showing a liability for tax was filed by the individual for the preceding taxable year and such preceding year was a taxable year of 12 months, or

(B) An amount equal to the tax computed, at the rates applicable to the taxable year, on the basis of the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on his return for, and the law applicable to, the preceding taxable year, or

(C) An amount equal to 70 percent (66⅔ percent in the case of individuals referred to in section 6073 (b), relating to income from farming) of the tax for the taxable year computed by placing on an annualized basis the taxable income for the months in the taxable year ending before the month in which the installment is required to be paid. For purposes of this subparagraph, the taxable income shall be placed on an annualized basis by—

(i) Multiplying by 12 (or, in the case of a taxable year of less than 12 months, the number of months in the taxable year) the taxable income (computed without deduction of personal exemptions) for the months in the taxable year ending before the month in which the installment is required to be paid,

(ii) Dividing the resulting amount by the number of months in the taxable year ending before the month in which such installment date falls, and

(iii) Deducting from such amount the deductions for personal exemptions allowable for the taxable year (such personal exemptions being determined as of the last date prescribed for payment of the installment); or

(2) An amount equal to 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income for the months in the taxable year ending before the month in which the installment is required to be paid.

(e) *Application of section in case of tax withheld on wages.* For purposes of applying this section—

(1) The estimated tax shall be computed without any reduction for the amount which the individual estimates as his credit under section 31 (relating to tax withheld at source on wages), and

(2) The amount of the credit allowed under section 31 for the taxable year shall be deemed a payment of estimated tax, and an equal part of such amount shall be deemed paid on each installment date (determined under section 6153) for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld, in which case the amounts so withheld shall be deemed payments of estimated tax on the dates on which such amounts were actually withheld.

(f) *Tax computed after application of credits against tax.* For purposes of subsections (b) and (d), the term "tax" means the tax imposed by chapter 1 reduced by the credits against tax allowed by part IV of subchapter A of chapter 1, other than the credit against tax provided by section 31 (relating to tax withheld on wages).

(g) *Short taxable year.* The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

(h) *Applicability.* This section shall apply only with respect to taxable years beginning after December 31, 1954; and section 294 (d) of the Internal Revenue Code of 1939 shall continue in force with respect to taxable years beginning before January 1, 1955.

§ 1.6654–1 Addition to the tax in the case of an individual.

(a) *In general.* (1) Section 6654 imposes an addition to the tax under chapter 1 of the Code in the case of any underpayment of estimated tax by an individual (with certain exceptions described in section 6654(d)). This addition to the tax is in addition to any applicable criminal penalties and is imposed whether or not there was reasonable cause for the underpayment. The amount of the underpayment for any installment date is the excess of—

(i) 70 percent (66⅔ percent in the case of individuals referred to in section 6073 (b), relating to income from farming) of the tax shown on the return for the taxable year or, if no return was filed, 70 percent (66⅔ percent in the case of individuals referred to in section 6073 (b), relating to income from farming) of the tax for such year, divided by the number of installment dates prescribed for such taxable year, over

(ii) The amount, if any, of the installment paid on or before the last day prescribed for such payment.

(2) The amount of the addition is determined at the rate of 6 percent per annum upon the underpayment of any installment of estimated tax for the period from the date such installment is required to be paid until the 15th day of the fourth month following the close of the taxable year, or the date such underpayment is paid, whichever is earlier. For purposes of determining the period of the underpayment (i) the date prescribed for the payment of any installment of estimated tax shall be determined without regard to any extension of time, and (ii) a payment of estimated tax on any installment date, to the extent that it exceeds the amount of the installment determined under subparagraph (1) (i) of this paragraph for such installment date, shall be considered a payment of any previous underpayment.

(3) In determining the amount of the installment paid on or before the last day prescribed for payment thereof, the estimated tax shall be computed without any reduction for the amount which the taxpayer estimates as his credit under section 31 (relating to tax withheld at source on wages), and the amount of such credit shall be deemed a payment of estimated tax. An equal part of the amount of such credit shall be deemed paid on each installment date (determined under section 6153) for the taxable year unless the taxpayer establishes the dates on which all amounts were actually withheld. In the latter case, all amounts withheld shall be con-

sidered as payments of estimated tax on the dates such amounts were actually withheld. Under section 31 the entire amount withheld during a calendar year is allowed as a credit against the tax for the taxable year which begins in such calendar year. However, where more than one taxable year begins in any calendar year no portion of the amount withheld during the calendar year will be treated as a payment of estimated tax for any taxable year other than the last taxable year beginning in such calendar year. The rules prescribed in this subparagraph for determining the time as of which the amount withheld shall be deemed paid are applicable even though such amount was withheld during a taxable year preceding that for which the credit is allowed.

(4) The term "tax" when used in subparagraph (1) (i) of this paragraph shall mean the tax imposed by chapter 1 of the Code reduced by all credits allowed by part IV, subchapter A of that chapter, except the credit provided by section 31, relating to tax withheld at source on wages. For the disallowance of certain credits in the case of taxpayers who elect to use the standard deduction or to pay the optional tax imposed by section 3, see section 36.

(b) *Statement relating to underpayment.* If there has been an underpayment of estimated tax as of any installment date prescribed for its payment and the taxpayer believes that one or more of the exceptions described in § 1.6654–2 precludes the assertion of the addition to the tax under section 6654, he should attach to his income tax return for the taxable year a Form 2210 showing the applicability of any exception upon which he relies.

(c) *Examples.* The method prescribed in paragraph (a) of this section for computing the addition to the tax may be illustrated by the following examples:

Example (1). An individual taxpayer files his return for the calendar year 1955 on April 15, 1956, showing a tax of $40,000. He has paid a total of $20,000 of estimated tax in four equal installments of $5,000 on each of the four installment dates prescribed for such year. No other payments were made prior to the date the return was filed. Since the amount of each installment paid by the last date prescribed for payment thereof is less than one-quarter of 70 percent of the tax shown on the return, the addition to the tax is applicable in respect of the underpayment existing as of each installment date and is computed as follows:

(1) Amount of tax shown on return	$40,000
(2) 70 percent of item (1)	28,000
(3) One-fourth of item (2)	$7,000
(4) Deduct amount paid on each installment date	6,000
(5) Amount of underpayment for each installment date (item (3) minus item (4))	2,000
(6) Addition to the tax:	
1st installment—period 4–15–55 to 4–15–56	$120
2d installment—period 6–15–55 to 4–15–56	100
3d installment—period 9–15–55 to 4–15–56	70
4th installment—period 1–15–56 to 4–15–56	30
Total	320

Example (2). An individual taxpayer files his return for the calendar year 1955 on April 15, 1956, showing a tax of $30,000. The requirements of section 6015 (a) were first met after April 1 and before June 2, 1955, and a total of $18,000 of estimated tax was paid in three equal installments of $6,000 on each of the three installment dates prescribed for such year. Since the amount of each installment paid by the last date prescribed for payment thereof is less than one-third of 70 percent of the tax shown on the return, the addition to the tax is applicable in respect of the underpayment existing as of each installment date and is computed as follows:

(1) Amount of tax shown on return	$30,000
(2) 70 percent of item (1)	21,000
(3) One-third of item (2)	$7,000
(4) Deduct amount paid on each installment date	6,000
(5) Amount of underpayment for each installment date (item (3) minus item (4))	1,000
(6) Addition to the tax:	
1st installment—period 6–15–55 to 4–15–56	$50
2d installment—period 9–15–55 to 4–15–56	35
3d installment—period 1–15–56 to 4–15–56	15
Total	100

§ 1.6654–2 Exceptions to imposition of the addition to the tax in the case of individuals.

(a) *In general.* The addition to the tax under section 6654 will not be imposed for any underpayment of any installment of estimated tax if, on or before the date prescribed for payment of the installment, the total amount of all payments of estimated tax made equals or exceeds the least of the following amounts—

(1) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were the tax shown on the return for the preceding taxable year, provided that the preceding taxable year was a year of 12 months and a return showing a liability for tax was filed for such year;

(2) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to a tax determined on the basis of the tax rates and the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year, in the case of an individual required to file a return for such preceding taxable year;

(3) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to 70 percent (66⅔ percent in the case of individuals referred to in section 6073 (b), relating to income from farming) of the tax computed by placing on an annual basis the taxable income for the calendar months in the taxable year preceding such date. The taxable income shall be placed on an annual basis by—

(i) Multiplying by 12 (or the number of months in the taxable year if less than 12) the taxable income (computed without the standard deduction and without the deductions for personal exemptions), or the adjusted gross income if the standard deduction is to be used, for such calendar months,

(ii) Dividing the resulting amount by the number of such calendar months, and

(iii) Deducting from such amount the standard deduction, if applicable, and the deductions for personal exemptions (such personal exemptions being determined as of the date prescribed for payment); or

(4) An amount equal to 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income for the calendar months in the taxable year preceding the date prescribed for payment.

In the case of a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441 (f), the rules prescribed by paragraph (b) of § 1.441–2 shall be applicable in determining, for purposes of subparagraph (1) of this paragraph, whether a taxable year was a year of 12 months and, for purposes of subparagraphs (3) and (4) of this paragraph, the number of calendar months in a taxable year preceding the date prescribed for payment of an installment of estimated tax. For the rule to be applied in determining taxable income for any period described in subparagraphs (3) and (4) of this paragraph in the case of a taxpayer who employs accounting periods (e. g., thirteen 4-week periods or four 13-week periods) none of which terminates with the end of the applicable period described in subparagraph (3) or (4) of this paragraph, see paragraph (a) (5) of § 1.6655–2.

(b) *Meaning of terms.* As used in this section and § 1.6654–3—

(1) The term "tax" means the tax imposed by chapter 1 of the Code reduced by the credits against tax allowed by part IV, subchapter A, of such chapter, other than the credit against tax provided by section 31 (relating to tax withheld on wages), and without reduction for any payments of estimated tax.

(2) The credits against tax allowed by part IV, subchapter A, chapter 1 of the Code, are—

(i) In the case of the exception described in paragraph (a) (1) of this section, the credits shown on the return for the preceding taxable year,

(ii) In the case of the exception described in paragraph (a) (2) of this section, the credits shown on the return for the preceding taxable year, except that if the amount of any such credit would be affected by any change in rates or status with respect to personal exemptions, the credits shall be determined by reference to the rates and status applicable to the current taxable year, and

(iii) In the case of the exceptions described in paragraph (a) (3) and (4) of this section, the credits computed under the law and rates applicable to the current taxable year.

A change in rate may be either a change in the rate of tax, such as a change in the rate of the tax imposed by section 1, or a change in any percentage affecting the computation of the credit, such as a change in the rate of withholding under chapter 3 of the Code or a change in the percentage of dividends received specified in section 34(a). The application of the preceding sentence may be illustrated by the following examples:

Example (1). Assume the percentage of dividends received which, subject to the limitations in section 34 (b), is allowed as a credit against the tax under section 34 (a) is changed from 4 to 5 percent. In determining the applicability of the exception described in paragraph (a)(2) of this section to an underpayment of estimated tax for the year in which such percentage changes, the 5 percent rate is applicable in determining the amount of the credit under section 34.

Example (2). Assume the rate of tax under section 1 on the first $2,000 of taxable income is changed from 20 percent to 18 percent. The credit allowed under section 37 (a) for retirement income is determined at the rate applicable to the first $2,000 of taxable income. In determining the applicability of the exception described in paragraph (a)(2) of this section to an underpayment of estimated tax for the year during which such change occurs, the 18 percent rate is applicable in determining the amount of the credit for retirement income under section 37.

(3) The term "return for the preceding taxable year" means the income tax return for such year which is required by section 6012 (a) (1).

(c) *Examples.* The following examples illustrate the application of the exceptions to the imposition of the addition to the tax for an underpayment of estimated tax, in the case of an individual whose taxable year is the calendar year:

Example (1). T, a married man with one child and a dependent parent, files a joint return with his spouse, W, for 1955 on April 15, 1956, showing taxable income of $44,000 and a tax of $16,760. T and W had filed a joint declaration of estimated tax on April 15, 1955, showing an estimated tax of $10,000 which was paid in four equal installments of $2,500 each on April 15, June 15, and September 15, 1955, and January 15, 1956. The balance of $6,760 was paid with the return. T and W have an underpayment of estimated tax of $483 (¼ of 70% of $16,760, less $2,500) for each installment date. The 1954 calendar year return of T and W showed a liability of $10,000. Since the total amount of estimated tax paid by each installment date equalled the amount that would have been required to be paid on or before each of such dates if the estimated tax were the tax shown on the return for the preceding year, the exception described in paragraph (a) (1) of this section applies and no addition to the tax will be imposed.

Example (2). Assume the same facts as in example (1), except that the joint return of T and W for 1954 showed taxable income of $32,000 and a tax liability of $10,400. Assume further that only two personal exemptions under section 151 appeared on the 1954 return. The exception described in paragraph (a) (1) of this section would not apply. However, T and W are entitled to four exemptions under section 151 for 1955. Taxable income for 1954 based on four exemptions, but otherwise on the basis of the facts shown on the 1954 return, would be $30,800. The tax on such amount in the case of a joint return would be $9,836. Since the total amount of estimated tax paid by each installment date exceeds the amount which would have been required to be paid on or before each of such dates if the estimated tax were $9,836, the exception described in paragraph (a) (2) of this section applies and no addition to the tax will be imposed.

Example (3). A and B, his spouse, filed a joint return for the calendar year 1955, showing a tax liability of $10,000, attributable primarily to income received during the last quarter of the year. Their aggregate payments of estimated tax on or before September 15, 1955, total $1,312.50, representing three installments of $437.50 paid on each of the first three installment dates prescribed for the taxable year. There was an underpayment on each of these dates since the installment paid, $437.50, was less than $1,750 (¼ of 70 percent of $10,000). Assume that the exceptions described in paragraph (a) (1) and (2) of this section do not apply. Actual taxable income for the three months ending March 31, 1955, was $2,000 and for the five months ending May 31, 1955, was $4,500. Since the amounts paid by the April 15 and June 15 installment dates, $437.50 and $875, respectively, exceeded $360 and $819 (90 percent of the tax determined on actual taxable income of $2,000 and $4,500, respectively, on the basis of a joint return), the exception described in paragraph (a) (4) of this section applies and no addition to the tax will be imposed for the underpayments on the April 15 and June 15 installment dates. Actual taxable income, assuming A and B did not elect to use the standard deduction, for the eight months ending August 31, 1955, was $7,000. Since the total amount paid by the September 15 installment date, $1,312.50, was less than $1,314 (90 percent of the tax on $7,000 of taxable income, determined on the basis of a joint return), the exception described in paragraph (a) (4) of this section does not apply to the September 15 installment. However, the exception described in paragraph (a) (3) of this section does apply in accordance with the following computation:

Taxable income for the period ending Aug. 31, 1955 (without deduction for personal exemptions) on an annual basis ($8,200×12÷8)	$12,300.00
Deduction for two personal exemptions	1,200.00
	11,100.00
Tax on $11,100 (on the basis of a joint return)	2,486.00
¾ of 70 percent of $2,486	1,305.15
Amount paid by Sept. 15, 1955	1,312.50

Example (4). Assume the same facts as in example (3) and assume further that adjusted gross income for the eight months ending August 31, 1955, was $8,700 and the amount of deductions (other than the deduction for personal exemptions) not allowable in determining adjusted gross income aggregate only $500. If A and B elect, they may use the standard deduction in computing the tax for purposes of the exceptions described in paragraph (a) (3) and (4) of this section. Taxable income, for purposes of the exception described in paragraph (a) (4) of this section would be reduced to $6,630 with the use of the standard deduction ($8,700 less $1,200 for two personal exemptions and $870 for the standard deduction). The tax thereon is $1,378.60. Since the amount paid by the September 15 installment date, $1,312.50, exceeds $1,180.74 (90 percent of $1,378.60), the exception described in paragraph (a) (4) of this section applies. The exception described in paragraph (a) (3) of this section also applies in accordance with the following computation:

Adjusted gross income for period ending Aug. 31, 1955	$8,700.00
Adjusted gross income annualized ($8,700×12÷8)	13,050.00
Taxable income annualized ($13,050 minus $1,200 for two personal exemptions and $1,000 for standard deduction)	10,850.00
Tax on $10,850 (on basis of joint return)	2,421.00
Three-fourths of 70 percent of $2,421	1,271.02
Amount paid by Sept. 15, 1955	1,312.50

Example (5). H was a married individual, 78 years of age, who filed a joint return with his wife, W, for the calendar year 1956. W, who was 70 years of age, had no income during the year. H had taxable income in the amount of $7,000 for the eight-month period ending on August 31, 1956, which included $2,000 of dividend income (after excluding $50 under section 116) and $900 of rental income. The $7,000 figure also reflected a deduction of $2,400 for personal exemptions ($600×4), since H and W were both over 65 years of age. The application of the exception described in paragraph (a) (3) of this section to an underpayment of estimated tax on the September 15th installment date may be illustrated by the following computation:

Taxable income for the period ending August 31, 1956 (without deduction for personal exemptions) on an annual basis ($9,400×12÷8)		$14,100.00
Deduction for personal exemptions		2,400.00
Taxable income on an annual basis		11,700.00
Tax (on the basis of a joint return)		2,642.00
Dividends received for 8-month period	$2,050	
Less: Amount excluded from gross income under section 116	50	
Dividends included in gross income	2,000	
Dividend income annualized ($2,000×12÷8)	3,000	
Dividends received credit under section 34 (4 percent of $3,000)		120.00
Tax less dividends received credit		2,522.00
Retirement income (as defined in section 37 (c)) includes:		
Dividend income (to extent included in gross income)	$2,000	
Rental income	900	
Total retirement income	2,900	
Limit on amount of retirement income under section 37 (d)	1,200	
Retirement income credit under section 37 (20 percent of $1,200)		240.00
Tax less credits under section 34 and section 37		2,282.00
Amount determined under the exception described in paragraph (a) (3) of this section (¾ of 70 percent of $2,282)		1,198.05

(d) *Determination of taxable income for installment periods*—(1) *In general.* (i) In determining the applicability of the exceptions described in paragraph (a) (3) and (4) of this section, there must be an accurate determination of the amount of income and deductions for the calendar months in the taxable year preceding the installment date as of which the determination is made, that is, for the period terminating with the last day of the third, fifth, or eighth month of the taxable year. For example, a taxpayer distributes year-end bonuses to his em-

ployees but does not determine the amount of the bonuses until the last month of the taxable year. He may not deduct any portion of such year-end bonuses in determining his taxable income for any installment period other than the final installment period for the taxable year, since deductions are not allowable until paid or accrued, depending on the taxpayer's method of accounting.

(ii) If a taxpayer on an accrual method of accounting wishes to use either of the exceptions described in paragraph (a) (3) and (4) of this section, he must establish the amount of income and deductions for each applicable period. If his income is derived from a business in which the production, purchase, or sale of merchandise is an income-producing factor requiring the use of inventories, he will be unable to determine accurately the amount of his taxable income for the applicable period unless he can establish, with reasonable accuracy, his cost of goods sold for the applicable installment period. The cost of goods sold for such period shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such installment period is of gross receipts from sales for the entire taxable year.

(2) *Members of partnerships.* The provisions of this subparagraph shall apply in determining the applicability of the exceptions described in paragraph (a) (3) and (4) of this section to an underpayment of estimated tax by a taxpayer who is a member of a partnership.

(i) There shall be taken into account—

(*a*) The partner's distributive share of partnership items set forth under section 702,

(*b*) The amount of any guaranteed payments under section 707 (c), and

(*c*) Gains or losses on partnership distributions which are treated as gains or losses on sales of property.

In determining a partner's taxable income for the months in his taxable year which precede the month in which the installment date falls, the partner shall take into account items set forth in section 702 for any partnership taxable year ending with or within his taxable year to the extent that such items are attributable to months in such partnership taxable year which precede the month in which the installment date falls. In addition, a partner shall include in his taxable income for the months in his taxable year which precede the month in which the installment date falls guaranteed payments from the partnership to the extent that such guaranteed payments are includible in his taxable income for such months. See section 706 (a), section 707 (c) and paragraph (c) of § 1.707–1.

(ii) The provisions of subdivision (i) (*a*) and (*b*) of this subparagraph may be illustrated by the following examples:

Example (1). A, whose taxable year is the calendar year, is a member of a partnership whose taxable year ends on January 31st. A must take into account, in determining his taxable income for the installment due on April 15, 1955, all of his distributive share of partnership items described in section 702 and the amount of any guaranteed payments made to him which were deductible by the partnership in the partnership taxable year beginning on February 1, 1954, and ending on January 31, 1955.

Example (2). Assume that the taxable year of the partnership of which A, a calendar year taxpayer, is a member ends on June 30th. A must take into account in the determination of his taxable income for the installment due on April 15, 1955, his distributive share of partnership items described in section 702 for the period July 1, 1954, through March 31, 1955; for the installment due on June 15, 1955, he must take into account such amounts for the period July 1, 1954, through May 31, 1955; and for the installment due on September 15, 1955 he must take into account such amounts for the entire partnership taxable year of July 1, 1954, through June 30, 1955 (the date on which the partnership taxable year ends).

(3) *Beneficiaries of estates and trusts.* In determining the applicability of the exceptions described in paragraph (a) (3) and (4) of this section as of any installment date, the beneficiary of an estate or trust must take into account his distributable share of income from the estate or trust for the applicable period (whether or not actually distributed) if the trust or estate is required to distribute income to him currently. If the estate or trust is not required to distribute income currently, only the amounts actually distributed to the beneficiary during such period must be taken into account. If the taxable year of the beneficiary and the taxable year of the estate or trust are different, there shall be taken into account the beneficiary's distributable share of income, or the amount actually distributed to him as the case may be, during the months in the taxable year of the estate or trust ending within the taxable year of the beneficiary which precede the month in which the installment date falls. See subparagraph (2) of this paragraph for examples of a similar rule which is applied when a partner and the partnership of which he is a member have different taxable years.

(e) *Special rule in case of change from joint return or separate return for the preceding taxable year*—(1) *Joint return to separate return.* In determining the applicability of the exceptions described in paragraph (a) (1) and (2) of this section to an underpayment of estimated tax, a taxpayer filing a separate return who participated in the filing of a joint return for the preceding taxable year, shall be subject to the following rule: The tax—

(i) Shown on the return for the preceding taxable year, or

(ii) Based on the tax rates and personal exemptions for the taxable year but otherwise determined on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year,

shall be that portion of the tax which bears the same ratio to the whole of the tax as the amount of tax for which the taxpayer would have been liable bears to the sum of the taxes for which the taxpayer and his spouse would have been liable had each spouse filed a separate return for the preceding taxable year.

(2) *Example.* The rule in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. H and W filed a joint return for the calendar year 1955 showing taxable income of $20,000 and a tax of $5,280. Of the $20,000 taxable income, $18,000 was attributable to H, and $2,000 was attributable to W. H and W filed separate returns for 1956. The tax shown on the return for the preceding taxable year, for purposes of determining the applicability of the exception described in paragraph (a) (1) of this section to an underpayment of estimated tax by H for 1956, is determined as follows:

Taxable income of H for 1955–$18,000	
Tax on $18,000 (on basis of separate return)	$6,200
Taxable income of W for 1955–$2,000	
Tax on $2,000 (on basis of separate return)	400
Aggregate tax of H and W (on basis of separate returns)	$6,600
Portion of 1955 tax shown on joint return attributable to H ($\frac{6200}{6600} \times 5280$)	4,960

(3) *Separate return to joint return.* In the case of a taxpayer who participates in the filing of a joint return for the taxable year with respect to which there is an underpayment of estimated tax and who filed a separate return for the preceding taxable year—

(i) The tax shown on the return for the preceding taxable year, for purposes of determining the applicability of the exception described in paragraph (a) (1) of this section, shall be the sum of both the tax shown on the return of the taxpayer and the tax shown on the return of the taxpayer's spouse for such preceding year, and

(ii) The facts shown on both the taxpayer's return and the return of his spouse for the preceding taxable year shall be taken into account for purposes of determining the applicability of the exception described in paragraph (a) (2) of this section.

(4) *Example.* The rules described in subparagraph (3) of this paragraph may be illustrated by the following example:

Example. H and W filed separate income tax returns for the calendar year 1954 showing tax liabilities of $2,640 and $350, respectively. In 1955 they married and participated in the filing of a joint return for that year. Thus, for the purpose of determining the applicability of the exceptions described in paragraph (a) (1) and (2) of this section to an underpayment of estimated tax for the year 1955, the tax shown on the return for the preceding taxable year is $2,990 ($2,640 plus $350).

§ 1.6654–3 Short taxable years of individuals.

(a) *In general.* The provisions of section 6654, with certain modifications relating to the application of subsection (d) thereof, which are explained in paragraph (b) of this section, are applicable in the case of a short taxable year for which a declaration is required to be filed. (See § 1.6015 (g)–1 for requirement of declaration for short taxable year.)

(b) *Rules as to application of section 6654 (d).* (1) In any case in which the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual account-

ing periods, in determining the tax—

(i) Shown on the return for the preceding taxable year (for purposes of section 6654 (d) (1) (A)), or

(ii) Based on the personal exemptions and rates for the current taxable year but otherwise on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year (for purposes of section 6654 (d) (1) (B)),

the tax will be reduced by multiplying it by the number of months in the short taxable year and dividing the resulting amount by 12.

(2) If the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in annualizing the income for the months in the taxable year preceding an installment date, for purposes of section 6654 (d) (1) (C), the personal exemptions allowed as deductions under section 151 shall be reduced to the same extent that they are reduced under section 443 (c) in computing the tax for a short taxable year.

(3) If "the preceding taxable year" referred to in section 6654 (d) (1) (B) was a short taxable year, the tax computed on the basis of the facts shown on the return for such preceding year, for purposes of determining the applicability of the exception described in section 6654 (d) (1) (B), shall be the tax computed on the annual basis in the manner described in section 443 (b) (1) (prior to its reduction in the manner described in the last sentence thereof). If the tax rates or the taxpayer's status with respect to personal exemptions for the taxable year with respect to which the underpayment occurs differ from such rates or status applicable to the preceding taxable year, the tax determined in accordance with the preceding sentence shall be recomputed to reflect the rates and status applicable to the year with respect to which the underpayment occurs.

§ 1.6654–4 Applicability.

Section 6654 is applicable only with respect to taxable years beginning after December 31, 1954. Section 294(d) of the Internal Revenue Code of 1939 shall continue in force with respect to taxable years beginning before January 1, 1955.

§ 1.6655 Statutory provisions; failure by corporation to pay estimated income tax.

SEC. 6655. *Failure by corporation to pay estimated income tax*—(a) *Addition to the tax.* In case of any underpayment of estimated tax by a corporation, except as provided in subsection (d), there shall be added to the tax under chapter 1 for the taxable year an amount determined at the rate of 6 percent per annum upon the amount of the underpayment (determined under subsection (b)) for the period of the underpayment (determined under subsection (c)).

(b) *Amount of underpayment* For purposes of subsection (a), the amount of the underpayment shall be the excess of—

(1) The amount of the installment which would be required to be paid if the estimated tax were equal to 70 percent of the tax shown on the return for the taxable year or, if no return was filed, 70 percent of the tax for such year, over

(2) The amount, if any, of the installment paid on or before the last date prescribed for payment.

(c) *Period of underpayment.* The period of the underpayment shall run from the date the installment was required to be paid to whichever of the following dates is the earlier—

(1) The 15th day of the third month following the close of the taxable year.

(2) With respect to any portion of the underpayment, the date on which such portion is paid. For purposes of this paragraph, a payment of estimated tax on the 15th day of the 12th month shall be considered a payment of any previous underpayment only to the extent such payment exceeds the amount of the installment determined under subsection (b) (1) for the 15th day of the 12th month.

(d) *Exception.* Notwithstanding the provisions of the preceding subsections, the additions to the tax with respect to any underpayment of any installment shall not be imposed if the total amount of all payments of estimated tax made on or before the last date prescribed for the payment of such installment equals or exceeds the amount which would have been required to be paid on or before such date if the estimated tax were whichever of the following is the lesser—

(1) The tax shown on the return of the corporation for the preceding taxable year reduced by $100,000, if a return showing a liability for tax was filed by the corporation for the preceding taxable year and such preceding year was a taxable year of 12 months.

(2) An amount equal to the tax computed at the rates applicable to the taxable year but otherwise on the basis of the facts shown on the return of the corporation for, and the law applicable to, the preceding taxable year.

(3) (A) An amount equal to 70 percent of the tax for the taxable year computed by placing on an annualized basis the taxable income:

(i) for the first 6 months or for the first 8 months of the taxable year, in the case of the installment required to be paid in the ninth month, and

(ii) for the first 9 months or for the first 11 months of the taxable year, in the case of the installment required to be paid in the twelfth month.

(B) For purposes of this paragraph, the taxable income shall be placed on an annualized basis by—

(i) Multiplying by 12 the taxable income referred to in subparagraph (A), and

(ii) Dividing the resulting amount by the number of months in the taxable year (6 or 8, or 9 or 11, as the case may be) referred to in subparagraph (A).

(e) *Definition of tax.* For purposes of subsections (b), (d) (2), and (d) (3), the term "tax" means the excess of—

(1) The tax imposed by section 11 or 1201 (a), or subchapter L of chapter 1, whichever is applicable, over

(2) The sum of—

(A) $100,000, and

(B) The credits against tax provided in part IV of subchapter A of chapter 1.

(f) *Short taxable year.* The application of this section to taxable years of less than 12 months shall be in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.6655–1 Addition to the tax in the case of a corporation.

(a) *In general.* (1) Section 6655 imposes an addition to the tax under chapter 1 of the Code in the case of any underpayment of estimated tax by a corporation (with certain exceptions described in section 6655(d)). This addition to the tax is in addition to any applicable criminal penalties and is imposed whether or not there was reasonable cause for the underpayment. The amount of the underpayment for any installment date is the excess of—

(i) 70 percent of the tax shown on the return for the taxable year or, if no return was filed, 70 percent of the tax for such year, multiplied by the percentage of the estimated tax for the taxable year which is required to be paid, and divided by the number of installment dates prescribed for such taxable year, over

(ii) The amount, if any, of the installment paid on or before the last day prescribed for such payment.

(2) The amount of the addition is determined at the rate of 6 percent per annum upon the underpayment of any installment of estimated tax for the period from the date such installment is required to be paid until the 15th day of the third month following the close of the taxable year, or the date such underpayment is paid, whichever is earlier. For purposes of determining the period of the underpayment (i) the date prescribed for the payment of either installment of estimated tax shall be determined without regard to any extension of time, and (ii) a payment of estimated tax on the 15th day of the last month of the taxable year, to the extent that it exceeds the amount of the installment determined under subparagraph (1) (i) of this paragraph for such date, shall be considered a payment of the previous underpayment, if any.

(3) The term "tax" as used in subparagraph (1) (i) of this paragraph means the excess of the tax imposed by section 11 or section 1201 (a), or subchapter L, chapter 1 of the Code, whichever is applicable, over the sum of $100,000 and the credits against tax provided by sections 32 and 33.

(4) For special rules relating to the determination of the amount of the underpayment in the case of a corporation whose income is included in a consolidated return, see § 1.1502–49.

(b) *Statement relating to underpayment.* If there has been an underpayment of estimated tax as of the installment date prescribed for its payment and the taxpayer believes that one or more of the exceptions described in § 1.6655–2 precludes the assertion of the addition to the tax under section 6655, it should attach to its income tax return for the taxable year a Form 2220 showing the applicability of any exception upon which the taxpayer relies.

(c) *Example.* The method prescribed in paragraph (a) of this section of computing the addition to the tax may be illustrated by the following example:

Example. A corporation using the calendar year basis reported on its declaration for 1955, estimated tax in the amount of $50,000. It made payments of $2,500 each on September 15, 1955, and December 15, 1955. On March 15, 1956, it filed its final income tax return showing a tax liability of $200,000. Since the amount of each of the two installments paid by the last date prescribed for

payment thereof was less than 5 percent of 70 percent of the tax shown on the return, the addition to the tax under section 6655 (a) is applicable and is computed as follows:

(1) Tax as defined in paragraph (a) of this section ($200,000–$100,000 (no credits allowable under sections 32 and 33))	$100,000
(2) 70% of item (1)	70,000
(3) Amount of estimated tax required to be paid on each installment date (5% of $70,000)	3,500
(4) Deduct amount paid on each installment date	2,500
(5) Amount of underpayment for each installment date (item (3) minus item (4))	1,000
(6) Addition to the tax:	
First installment—period 9–15–55 to 3–15–56	$30
Second installment—period 12–15–55 to 3–15–56	15
Total	45

§ 1.6655–2 Exceptions to imposition of the addition to the tax in the case of corporations.

(a) *In general.* The addition to the tax under section 6655 will not be imposed for any underpayment of any installment of estimated tax if, on or before the date prescribed for payment of the installment, the total amount of all payments of estimated tax made equals or exceeds the amount which would have been required to be paid on or before such date if the estimated tax were the least of the following amounts—

(1) The tax shown on the return for the preceding taxable year, provided that the preceding taxable year was a year of 12 months and a return showing a liability for tax was filed for such year;

(2) An amount equal to a tax determined on the basis of the tax rates for the taxable year but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year, in the case of a corporation required to file a return for such preceding taxable year; or

(3) An amount equal to 70 percent of the tax determined by placing on an annual basis the taxable income for either the first 6 months or the first 8 months of the taxable year (whichever results in no addition being imposed), in the case of the installment required to be paid by the 15th day of the 9th month, or for either the first 9 months or the first 11 months of the taxable year (whichever results in no addition being imposed), in the case of the installment required to be paid by the 15th day of the 12th month. The taxable income so determined shall be placed on an annual basis by—

(i) Multiplying it by 12, and

(ii) Dividing the resulting amount by the number of months in the taxable year for which the taxable income was so determined.

(4) In the case of a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441 (f), the rules prescribed by paragraph (b) of § 1.441–2 shall be applicable in determining, for purposes of subparagraph (1) of this paragraph, whether a taxable year was a year of 12 months and in determining, for purposes of subparagraph (3) of this paragraph, the commencement of the 6- or 8-month period or the 9- or 11-month period, whichever is applicable. For example, if a taxable year begins on December 26, 1956, taxable income for the first 6 months of such year, for purposes of subparagraph (3) of this paragraph, shall be taxable income for the period beginning on December 26, 1956, and ending on June 30, 1957, since such taxable year is deemed to commence on January 1, 1957, under section 441 (f).

(5) If the end of any accounting period employed by the taxpayer (e. g., any of either thirteen 4-week periods or four 13-week periods) does not correspond to the termination date of the applicable 6- or 8-month or 9- or 11-month period, taxable income shall be determined from the beginning of the taxable year to the close of the accounting period ending immediately before the termination date of the applicable 6- or 8-month or 9- or 11-month period and to the close of the accounting period within which such termination date falls. There shall be determined that portion of the difference between the two amounts of taxable income so determined which bears the same ratio to the total difference between such amounts as the number of days from the close of the first such accounting period to the close of such applicable 6- or 8-month or 9- or 11-month period bears to the total number of days between the termination dates of such two accounting periods. The portion of the difference between such amounts so determined shall then be added to (or subtracted from) taxable income determined to the close of the first such accounting period to determine taxable income for such applicable 6- or 8-month or 9- or 11-month period. For example, a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441 (f) has a taxable year beginning on December 26, 1956, and thirteen 4-week accounting periods are employed in determining taxable income. Taxable income from December 26, 1956, to the close of the 4-week accounting period ending on June 11, 1957, is $200,000, and taxable income from December 26, 1956, to the close of the 4-week accounting period ending on July 9, 1957, is $228,000. Taxable income for the 6-month period ending on June 30, 1957, is $219,000 ($200,000+(19×28,000÷28)).

(b) *Meaning of terms.* (1) For the purpose of the exceptions described in paragraph (a) of this section, the term "tax" means the excess of the tax imposed by section 11 or 1201 (a), or subchapter L, chapter 1 of the Code, whichever is applicable, over the sum of $100,000 plus the credits against the tax allowed by sections 32 and 33.

(2) The credits against the tax allowed by sections 32 and 33 are—

(i) In the case of the exception described in paragraph (a) (1) of this section, such credits shown on the return for the preceding taxable year,

(ii) In the case of the exception described in paragraph (a) (2) of this section, such credits shown on the return for the preceding taxable year, except that if the amount of any such credit would be affected by any change in rates, the credits shall be determined by reference to the rates applicable to the current taxable year, and

(iii) In the case of the exception described in paragraph (a) (3) of this section, such credits computed under the law and rates applicable to the current taxable year.

The provisions of subdivision (ii) of this subparagraph may be illustrated by the following example:

Example. Assume that during the taxable year within which the normal tax rate in section 11 changes from 30 percent to 25 percent, Corporation X has an underpayment of estimated tax. One-fourth of the taxable income of Corporation X for the taxable year preceding that in which such underpayment occurs was from sources within foreign country Y. The return of Corporation X for such preceding year shows taxable income of $325,000 and a tax, without regard to any credits, of $163,500. The credit allowed by section 33 on account of taxes paid to foreign country Y may not exceed one-fourth of such amount, or $40,875, under section 904. The tax for the preceding year, computed by using the rates applicable to the year during which the underpayment occurs, would be reduced to $147,250 and the limitation under section 904 on the credit allowed under section 33 for taxes paid to foreign country Y would be reduced to $36,812.50, for purposes of determining the applicability of the exception described in paragraph (a) (2) of this section. Therefore, the exception described in paragraph (a) (2) of this section will be applicable if, on or before the date prescribed for such payment, the total amount paid by Corporation X equals or exceeds the amount which would have been required to be paid by such date if the estimated tax were $10,437.50 ($147,250 less ($100,000÷$36,812.50)).

(3) For the purpose of the exceptions described in paragraph (a) (1) and (2) of this section, the term "return for the preceding taxable year" means the income tax return for such year which is required by section 6012 (a) (2).

(c) *Examples.* The application of the exceptions to the imposition of the addition to tax may be illustrated by examples employing the following statement of facts:

STATEMENT OF FACTS

X, a corporation with a taxable year ending on March 31, filed a declaration on December 15, 1955, showing an estimated tax of $35,500 for its taxable year ending March 31, 1956. The first installment of $1,775 was paid with the filing of the declaration and the second installment in the same amount was paid on March 15, 1956. X reported a tax liability of $154,300 on its return due June 15, 1956. There was an underpayment of estimated tax in the amount of $125.50 on each installment date determined as follows:

(1) Tax as defined in paragraph (b) of this section ($154,300–$100,000)	$54,300.00
(2) 70% of item (1)	38,010.00
(3) 5% of item (2)	1,900.50
(4) Deduct amount paid on each installment date	1,775.00
(5) Amount of underpayment at each installment date (item (3) minus item (4))	125.50

The application of each exception described in paragraph (a) of this section is determined as follows:

(1) Assume X reported a liability of $163,500 on its return for the taxable year ending March 31, 1955. If the estimated tax were $163,500 reduced by $100,000, or $63,500, the amount which would have been required to be paid on or before each installment date would be 5 percent of $63,500, or $3,175. Since this amount exceeds the amount actually paid on each installment date ($1,775), the exception described in paragraph (a) (1) of this section does not apply.

(2) Since the corporation tax rates under section 11 are the same for the taxable years ending on March 31, 1955, and March 31, 1956, the amount of tax determined under paragraph (a) (2) of this section and the amount required to be paid on each installment date to qualify under the exception described therein are the same as the corresponding amounts determined under paragraph (a) (1) of this section. Accordingly, the exception described in paragraph (a) (2) of this section does not apply.

(3) X determined that its taxable income for the first 6 months and the first 8 months of the taxable year ended March 31, 1956, was $180,000 and $200,000, respectively, and that its taxable income for the first 9 months and the first 11 months was $264,000 and $319,000, respectively. The income for each period is annualized as follows:

$180,000 × 12 ÷ 6 = $360,000
$200,000 × 12 ÷ 8 = $300,000
$264,000 × 12 ÷ 9 = $352,000
$319,000 × 12 ÷ 11 = $348,000

To determine whether the installment payment made on December 15, 1955, equals or exceeds the amount which would have been required to be paid if the estimated tax were equal to 70 percent of the tax computed on the annualized income for either the 6- or 8-month period, the following computation is necessary:

	6 months	8 months
(1) Annualized income	$360,000.00	$300,000.00
(2) Tax on item (1) reduced by $100,000	81,700.00	50,500.00
(3) 70 percent of item (2)	57,190.00	35,350.00
(4) 5 percent of item (3)	2,859.50	1,767.50

Since the amount actually paid on December 15, 1955, $1,775, exceeds the amount which would have been required to be paid on such date ($1,767.50) if the estimated tax were 70 percent of the tax determined by placing on an annualized basis the taxable income for the first 8 months of the taxable year, the exception described in paragraph (a) (3) of this section applies and no addition to tax will be imposed for the underpayment of the installment paid on December 15, 1955. A similar computation must be made with respect to the annualized income for the 9- and 11-month periods to determine whether or not the addition to the tax will be imposed with respect to the underpayment of the March 15, 1956, installment. The computation follows:

	9 months	11 months
(1) Annualized income	$352,000.00	$348,000.00
(2) Tax on item (1) reduced by $100,000	77,540.00	75,460.00
(3) 70 percent of item (2)	54,278.00	52,822.00
(4) 10 percent of item (3)	5,427.80	5,282.20

Since the total amount of all payments of estimated tax actually paid on or before March 15, 1956, $3,550 ($1,775 × 2), does not equal or exceed the total amount which would have been required to be paid on or before such date if the estimated tax were 70 percent of the tax determined by placing on an annual basis the taxable income for either the 9- or 11-month period, the addition to the tax with respect to the underpayment of the March 15, 1956, installment must be imposed.

(d) *Determination of taxable income for portion of taxable year.* In determining the applicability of the exception described in paragraph (a) (3) of this section, there must be an accurate determination of the amount of income and deductions for the appropriate period, that is, for the first six, eight, nine, or eleven months of the taxable year. See paragraph (d) (1) of § 1.6654–2 for a description of a similar requirement with respect to individuals.

§ 1.6655–3 Short taxable years in the case of corporations.

(a) *In general.* The provisions of section 6655, with certain modifications relating to the application of subsection (d) thereof, which are explained in paragraph (b) of this section, are applicable in the case of a short taxable year for which a declaration is required to be filed. (See § 1.6016–4 for requirement of declaration for short taxable year.)

(b) *Rules as to application of section 6655 (d).* In any case in which the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in determining the tax—

(1) Shown on the return for the preceding taxable year (for purposes of section 6655 (d) (1));

(2) Based on the current year's rates but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year (for purposes of section 6655 (d) (2)); or

(3) Computed by placing taxable income for a portion of the current year on an annual basis under section 6655 (d) (3);

the tax will be reduced by multiplying it by the number of months in the short taxable year and dividing the resulting amount by 12. The application of the exception provided in section 6655 (d) (3) shall be determined as if the estimated tax were 70 percent of the tax so reduced.

(c) *Preceding taxable year a short taxable year.* If "the preceding taxable year" referred to in section 6655 (d) (2) was a short taxable year, the tax computed on the basis of the facts shown on the return for such preceding year, for purposes of determining the applicability of the exception described in section 6655 (d) (2), shall be the tax computed on the annual basis in the manner described in section 443 (b) (1) (prior to its reduction in the manner described in the last sentence thereof). If the tax rates for the taxable year with respect to which the underpayment occurs differ from the rates applicable to the preceding taxable year, the tax determined in accordance with the preceding sentence shall be recomputed using the rates applicable to the year with respect to which the underpayment occurs.

JEOPARDY, BANKRUPTCY, AND RECEIVERSHIPS

§ 1.6851 Statutory provisions; termination of taxable year.

SEC. 6851. *Termination of taxable year*—(a) *Income tax in jeopardy*—(1) *In general.* If the Secretary or his delegate finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the income tax for the current or the preceding taxable year unless such proceedings be brought without delay, the Secretary or his delegate shall declare the taxable period for such taxpayer immediately terminated, and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of such tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any proceeding in court brought to enforce payment of taxes made due and payable by virtue of the provisions of this section, the finding of the Secretary or his delegate, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of jeopardy.

(2) *Corporation in liquidation.* If the Secretary or his delegate finds that the collection of the income tax of a corporation for the current or the preceding taxable year will be jeopardized by the distribution of all or a portion of the assets of such corporation in the liquidation of the whole or any part of its capital stock, the Secretary or his delegate shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of such tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable.

(b) *Reopening of taxable period.* Notwithstanding the termination of the taxable period of the taxpayer by the Secretary or his delegate, as provided in subsection (a), the Secretary or his delegate may reopen such taxable period each time the taxpayer is found by the Secretary or his delegate to have received income, within the current taxable year, since a termination of the period under subsection (a). A taxable period so terminated by the Secretary or his delegate may be reopened by the taxpayer (other than a nonresident alien) if he files with the Secretary or his delegate a true and accurate return of the items of gross income and of the deductions and credits allowed under this title for such taxable period, together with such other information as the Secretary or his delegate may by regulations prescribe. If the taxpayer is a nonresident alien the taxable period so terminated may be reopened by him if he files, or causes to be filed, with the Secretary or his delegate a true and accurate return of his total income derived from all sources within the United States, in the manner prescribed in this title.

(c) *Citizens.* In the case of a citizen of the United States or of a possession of the United States about to depart from the United States, the Secretary or his delegate may, at his discretion, waive any or all of the requirements placed on the taxpayer by this section.

(d) *Departure of alien.* Subject to such exceptions as may, by regulations, be pre-

scribed by the Secretary or his delegate—

(1) No alien shall depart from the United States unless he first procures from the Secretary or his delegate a certificate that he has complied with all the obligations imposed upon him by the income tax laws.

(2) Payment of taxes shall not be enforced by any proceedings under the provisions of this section prior to the expiration of the time otherwise allowed for paying such taxes if, in the case of an alien about to depart from the United States, the Secretary or his delegate determines that the collection of the tax will not be jeopardized by the departure of the alien.

(e) *Furnishing of bond where taxable year is closed by the Secretary or his delegate.* Payment of taxes shall not be enforced by any proceedings under the provisions of this section prior to the expiration of the time otherwise allowed for paying such taxes if the taxpayer furnishes, under regulations prescribed by the Secretary or his delegate, a bond to insure the timely making of returns with respect to, and payment of, such taxes or any income or excess profits taxes for prior years.

[Sec. 6851 as amended by sec. 87, Technical Amendments Act 1958 (72 Stat. 1665)]

§ 1.6851–1 Termination of taxable period by district director.

(a) *Income tax in jeopardy*—(1) *In general.* If a taxpayer designs by immediate departure from the United States, or otherwise, to avoid the payment of income tax for the preceding or current taxable year, the district director may, upon evidence satisfactory to him, declare the taxable period for such taxpayer immediately terminated and cause to be served upon him notice and demand for immediate payment of the income tax for the short taxable period resulting from such termination, and of the income tax for the preceding taxable year, or so much of such tax as is unpaid. In such a case, the taxpayer is entitled to a deduction for his personal exemptions (as limited in the case of certain nonresident aliens) without any proration because of the short taxable period.

(2) *Corporations in liquidation.* If the district director finds that the collection of the income tax of a corporation for the current or the preceding taxable year will be jeopardized by the distribution of all or a portion of the assets of such corporation in the liquidation of the whole or any part of its capital stock, he shall declare the taxable period for such corporation immediately terminated and cause to be served upon the corporation notice and demand for immediate payment of the income tax for the short taxable period resulting from such termination, and of the income tax for the preceding taxable year, or so much of such tax as is unpaid.

(3) *Presumptive evidence of jeopardy.* In any proceeding in court brought to enforce payment of taxes made due and payable by virtue of the provisions of section 6851 and this paragraph, the finding of the district director shall be for all purposes presumptive evidence of jeopardy.

(4) *Bond.* For the provisions relating to the furnishing of a bond in lieu of making immediate payment of the taxes which become due by action pursuant to this paragraph, see § 1.6851–3.

(b) *Reopening of taxable period*—(1) *Income received after termination.* If a taxpayer whose taxable period has been terminated under section 6851 and paragraph (a) of this section receives other income subsequent to such termination within his current taxable year, the district director may reopen the period so terminated and may, in accordance with section 6851 and paragraph (a) of this section, again terminate the taxable period of such taxpayer. In such case, tax liability shall be computed for the period beginning with the first day of the current taxable year of the taxpayer and ending at the time of the later termination.

(2) *Return filed after termination.* When a taxpayer whose taxable period has been terminated under section 6851 and paragraph (a) of this section files the return required by paragraph (c) of this section, the taxable period so terminated shall be reopened.

(c) *Taxable year not affected by termination.* Notwithstanding any action by a district director under section 6851 and this section, a taxpayer shall file a return in accordance with section 6012 and the regulations thereunder for his current taxable year showing all items of gross income, deductions, and credits for such taxable year. The term "current taxable year" means the taxpayer's usual annual accounting period determined without regard to any action under section 6851 and this section. Any tax paid as a result of a termination under section 6851 and this section will be applied against the tax due for his current taxable year.

(d) *Evidence of compliance with income tax obligations.* Citizens of the United States or of possessions of the United States departing from the United States or its possessions will not be required to procure certificates of compliance or to present any other evidence of compliance with income tax obligations. However, for the rules relating to the furnishing of evidence of compliance with the income tax obligations by certain departing aliens, see § 1.6851–2.

§ 1.6851–2 Certificates of compliance with income tax laws by departing aliens.

(a) *In general*—(1) *Requirement.* Except as provided in subparagraph (2) of this paragraph, no alien, whether resident or nonresident, may depart from the United States unless he first procures a certificate that he has complied with all of the obligations imposed upon him by the income tax laws. In order to procure such a certificate, an alien who intends to depart from the United States (i) must file with the district director for the internal revenue district in which he is located the statements or returns required by paragraph (b) of this section to be filed before obtaining such certificate, (ii) must appear before such district director if the district director deems it necessary, and (iii) must pay any taxes required under paragraph (b) of this section to be paid before obtaining the certificate. Either such certificate of compliance, properly executed, or evidence that the alien is excepted under subparagraph (2) of this paragraph from obtaining the certificate must be presented at the point of departure. An alien who presents himself at the point of departure without a certificate of compliance, or evidence establishing that such a certificate is not required, will be subject at such departure point to examination by an internal revenue officer or employee and to the completion of returns and statements and payment of taxes as required by paragraph (b) of this section.

(2) *Exceptions*—(i) *Diplomatic representatives.* (a) Representatives of foreign governments bearing diplomatic passports, whether accredited to the United States or other countries, and members of their households shall not, upon departure from the United States or any of its possessions, be examined as to their liability for United States income tax or be required to obtain a certificate of compliance. If a foreign government does not issue diplomatic passports but merely indicates on passports issued to members of its diplomatic service the status of the bearer as a member of such service, such passports are considered as diplomatic passports for income tax purposes.

(b) Likewise, the servant of a representative described in (a) of this subdivision who accompanies any individual bearing a diplomatic passport upon departure from the United States or any of its possessions shall not be required, upon such departure, to obtain a certificate of compliance or to submit to examination as to his liability for United States income tax. If the departure of such a servant from the United States or any of its possessions is not made in the company of an individual bearing a diplomatic passport, the servant is required to obtain a certificate of compliance. However, such certificate will be issued to him on Form 2063 without examination as to his income tax liability upon presentation to the district director for the internal revenue district in which the servant is located of a letter from the chief of the diplomatic mission to which the servant is attached certifying (1) that the name of the servant appears on the "White List", a list of employees of diplomatic missions, and (2) that the servant is not obligated to the United States for any income tax, and will not be so obligated up to and including the intended date of departure.

(c) An alien who has filed with the Attorney General the waiver provided for under section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257 (b)), is not entitled to the exception provided by this subdivision.

(ii) *Alien visitors or tourists.* An alien visitor or tourist in the United States or any of its possessions shall not, upon departure therefrom, be examined as to his liability for United States income tax or be required to obtain a certificate of compliance provided—

(a) He was admitted solely on a B–2 visa;

(b) He has been in the United States or any of its possessions for not more than 60 consecutive days, whether or not within the same calendar year, or not more than a total of 60 days, whether or

not consecutive, during the calendar year;

(c) He has received no gross income from sources within the United States for the taxable year up to and including the date of his intended departure (and for the preceding taxable year in any case in which the period for making the income tax return for such preceding year has not expired); and

(d) He is not in default in making return of, or paying, United States income tax for any taxable year.

(iii) *Aliens in transit.* An alien in transit through the United States or any of its possessions who remains in the United States or a possession thereof for a period of not more than five days in any one trip shall not upon departure be examined as to his income tax liability or be required to procure a certificate of compliance, unless the internal revenue officer or employee at the point of departure is in possession of information indicating that the alien is obligated to the United States for income tax. This exception applies to any alien who is admitted on a C–1 visa or who is admitted under a contract, including a bond agreement, between a transportation line and the Attorney General pursuant to section 238(d) of the Immigration and Nationality Act (8 U.S.C. 1228(d)).

(iv) *Alien commuters.* An alien resident of Canada or Mexico who commutes between such country and the United States at frequent intervals for the purpose of employment and whose wages are subject to the withholding of tax shall not, upon departure from the United States, be examined as to his United States income tax liability or required to obtain a certificate of compliance, unless the internal revenue officer or employee at the point of departure is in possession of information indicating that collection of income tax from such alien will be jeopardized by his departure from the United States.

(b) *Issuance of certificate of compliance*—(1) *In general.* (i) Upon the departure of an alien required to secure a certificate of compliance under paragraph (a) of this section, the district director shall determine under section 6851 whether the departure of such alien jeopardizes the collection of any income taxes for the current or the preceding taxable year, but the district director may determine that jeopardy does not exist in some cases. If the district director finds that the departure of such an alien results in jeopardy, the taxable period of such alien will be terminated, and such alien will be required to file returns and make payment of taxes in accordance with subparagraph (4) of this paragraph. On the other hand, if the district director finds that the departure of such an alien does not result in jeopardy, such alien will be required to file returns in accordance with subparagraph (2) or (3) of this paragraph, but will not be required upon departure to pay income tax before the usual time for payment.

(ii) The fact that an alien intends to depart from the United States will justify a finding that jeopardy exists unless the district director is convinced that the alien (whether resident or not) will return to the United States or any of its possessions or unless the district director is convinced that the alien will leave sufficient property in the United States or its possessions to secure payment of his income taxes. The fact that a resident alien leaves a family in the United States or that an alien (whether resident or not) is engaged in a trade or business in the United States may provide such evidence.

(iii) A departing alien who wishes to establish that his departure does not result in jeopardy shall furnish to the district director a statement showing—

(a) The reason for his departure and facts evidencing his intention to return;

(b) The anticipated duration of his absence;

(c) The nature and extent of his business and property and of his family in the United States or any of its possessions; and

(d) Such other information as the district director may consider necessary to enable him to determine whether the departure of the alien will result in jeopardy.

(2) *Nonresident alien having no taxable income.* A statement on Form 2063 shall be filed with the district director by every nonresident alien individual required to obtain a certificate of compliance—

(i) Who is not in default in making return of, or paying, any United States income tax, and

(ii) Who has had no taxable income for the taxable year up to and including the date of his departure, and for the preceding taxable year where the period for making the income tax return for the preceding taxable year has not expired.

If the district director is satisfied that such nonresident alien fulfills the conditions of subdivisions (i) and (ii) of this subparagraph, he shall execute and issue to the departing alien the certificate of compliance attached to the Form 2063.

(3) *Alien whose taxable period is not terminated.* Any alien required to obtain a certificate of compliance (but not described in subparagraph (2) of this paragraph) whose taxable period is not terminated upon departure shall file with the district director—

(i) A return in duplicate on Form 1040C for the taxable year of his intended departure, showing income received, and reasonably expected to be received, during the entire taxable year within which the departure occurs;

(ii) Where the period for filing has not expired, the return required under section 6012 and § 1.6012–1 for the preceding taxable year; and

(iii) Any income tax returns which have not been filed as required.

Upon compliance by the alien with the foregoing requirements of this subparagraph, and payment of any income tax due and owing, the alien will be issued the certificate of compliance on the duplicate copy of Form 1040C completed to certify that the alien has complied with all of the obligations imposed upon him at the time of his departure by the income tax laws and the regulations thereunder with respect to income for his current and prior taxable years. A certificate of compliance so issued shall be subject to revocation by the district director if the taxable period is terminated upon a subsequent departure from the United States or any of its possessions during the same taxable year. A return on Form 1040C will not be required upon any such subsequent departure in the same taxable year unless the taxable period is terminated upon such subsequent departure. The return required under subdivision (i) of this subparagraph, if made for a taxable year beginning before January 1, 1960, may be made on a Form 1040D in lieu of a Form 1040C.

(4) *Alien whose taxable period is terminated.* Any alien required to obtain a certificate of compliance (but not described in subparagraph (2) of this paragraph) whose taxable period is terminated upon departure shall file with the district director—

(i) A return on Form 1040C for the short taxable period resulting from such termination, showing income received, and reasonably expected to be received, during the taxable year up to and including the date of departure;

(ii) Where the period for filing has not expired, the return required under section 6012 and § 1.6012–1 for the preceding taxable year; and

(iii) Any income tax returns which have not been filed as required.

Upon filing such returns, and paying the income tax required to be shown thereon and any other income tax due and owing, the departing alien will be furnished the certificate of compliance on the duplicate copy of Form 1040C completed to certify that the alien has complied with all the obligations imposed on him at the time of his departure by the income tax laws and regulations thereunder with respect to income received, and reasonably expected to be received, up to and including the date of departure. A departing alien may postpone payment of the tax required to be shown on the returns filed in accordance with subdivisions (i) and (ii) of this subparagraph until the usual time of payment by furnishing a bond as provided in § 1.6851–3.

(5) *Joint return on Form 1040C.* A departing alien may not file a joint return on Form 1040C unless—

(i) Such alien and his spouse may reasonably be expected to be eligible to file a joint return at the normal close of their taxable periods for which the return is made; and

(ii) If the taxable period of such alien is terminated, the taxable periods of both spouses are so terminated as to end at the same time.

(6) *Annual return.* Notwithstanding that Form 1040C has been filed for either the entire taxable year of departure or for a terminated period, the return required under section 6012 and § 1.6012–1 for such taxable year shall be filed. Any income tax paid on income shown on the return on Form 1040C shall be applied against the tax determined to be due on the income required to be shown on the

subsequent return under section 6012 and § 1.6012–1.

§ 1.6851–3 Furnishing of bond to insure payment.

If any income tax is made due and payable by virtue of the provisions of section 6851 and §§ 1.6851–1 and 1.6851–2, a taxpayer may, in lieu of making immediate payment thereof, furnish the district director a bond in an amount equal to the amount of tax (including interest thereon to the date of payment as calculated by the district director) payment of which is sought to be stayed, conditioned upon the timely filing of returns with respect to such tax and the payment of such tax at the time it would otherwise be payable without regard to the provisions of section 6851 and §§ 1.6851–1 and 1.6851–2. See section 7101 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration), relating to the form of bond and the sureties thereon.

PUBLIC LAW 74, 84TH CONGRESS

§ 1.9000–1 Statutory provisions.

The Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 134), provides as follows:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. *Repeal of sections 452 and 462*—(a) *Prepaid income.* Section 452 of the Internal Revenue Code of 1954 is hereby repealed.

(b) Reserves for estimated expenses, etc. Section 462 of the Internal Revenue Code of 1954 is hereby repealed.

SEC. 2. *Technical amendments.* The following provisions of the Internal Revenue Code of 1954 are hereby amended as follows:

(1) Subsection (c) of section 381 is amended by striking out paragraph (7) (relating to carryover of prepaid income in certain corporate acquisitions).

(2) The table of sections for subpart B of part II of subchapter E of chapter 1 (relating to taxable year for which items of gross income included) is amended by striking out

"Sec. 452. Prepaid income."

(3) The table of sections for subpart C of such part II (relating to taxable year for which deductions are taken) is amended by striking out—

"Sec. 462. Reserves for estimated expenses, etc."

SEC. 3. *Effective date.* The amendments made by this act shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

SEC. 4. *Saving provisions*—(a) *Filing of statement.* If—

(1) the amount of any tax required to be paid for any taxable year ending on or before the date of the enactment of this act is increased by reason of the enactment of this act, and

(2) the last date prescribed for payment of such tax (or any installment thereof) is before December 15, 1955,

then the taxpayer shall, on or before December 15, 1955, file a statement which shows the increase in the amount of such tax required to be paid by reason of the enactment of this act.

(b) *Form and effect of statement*—(1) *Form of statement, etc.* The statement required by subsection (a) shall be filed at the place fixed for filing the return. Such statement shall be in such form, and shall include such information necessary or appropriate to show the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this act, as the Secretary of the Treasury or his delegate shall by regulations prescribe.

(2) *Treatment as amount shown on return.* The amount shown on a statement filed under subsection (a) as the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this act shall, for all purposes of the internal revenue laws, be treated as tax shown on the return. Notwithstanding the preceding sentence, that portion of the amount of increase in tax for any taxable year which is attributable to a decrease (by reason of the enactment of this act) in the net operating loss for a succeeding taxable year shall not be treated as tax shown on the return.

(3) *Waiver of interest in case of payment on or before December 15, 1955.* If the taxpayer, on or before December 15, 1955, files the statement referred to in subsection (a) and pays in full that portion of the amount shown thereon for which the last date prescribed for payment is before December 15, 1955, then for purposes of computing interest (other than interest on overpayments) such portion shall be treated as having been paid on the last date prescribed for payment. This paragraph shall not apply if the amount shown on the statement as the increase in the amount of the tax required to be paid for the taxable year by reason of the enactment of this act is greater than the actual increase unless the taxpayer establishes, to the satisfaction of the Secretary of the Treasury or his delegate, that his computation of the greater amount was based upon a reasonable interpretation and application of sections 452 and 462 of the Internal Revenue Code of 1954, as those sections existed before the enactment of this act.

(c) *Special rules*—(1) *Interest for period before enactment.* Interest shall not be imposed on the amount of any increase in tax resulting from the enactment of this act for any period before the day after the date of the enactment of this act.

(2) *Estimated tax.* Any addition to the tax under section 294 (d) of the Internal Revenue Code of 1939 shall be computed as if this act had not been enacted. In the case of any installment for which the last date prescribed for payment is before December 15, 1955, any addition to the tax under section 6654 of the Internal Revenue Code of 1954 shall be computed as if this act had not been enacted.

(3) *Treatment of certain payments which taxpayer is required to make.* If—

(A) The taxpayer is required to make a payment (or an additional payment) to another person by reason of the enactment of this act, and

(B) The Internal Revenue Code of 1954 prescribes a period, which expires after the close of the taxable year, within which the taxpayer must make such payment (or additional payment) if the amount thereof is to be taken into account (as a deduction or otherwise) in computing taxable income for such taxable year,

then, subject to such regulations as the Secretary of the Treasury or his delegate may prescribe, if such payment (or additional payment) is made on or before December 15, 1955, it shall be treated as having been made within the period prescribed by such Code.

(4) *Treatment of certain dividends.* Subject to such regulations as the Secretary of the Treasury or his delegate may prescribe, for purposes of section 561 (a) (1) of the Internal Revenue Code of 1954, dividends paid after the 15th day of the third month following the close of the taxable year and on or before December 15, 1955, may be treated as having been paid on the last day of the taxable year, but only to the extent (A) that such dividends are attributable to an increase in taxable income for the taxable year resulting from the enactment of this act, and (B) elected by the taxpayer.

(5) *Determination of date prescribed.* For purposes of this section, the determination of the last date prescribed for payment or for filing a return shall be made without regard to any extension of time therefor and without regard to any provision of this section.

(6) *Regulations.* For requirement that the Secretary of the Treasury or his delegate shall prescribe all rules and regulations as may be necessary by reason of the enactment of this act, see section 7805 (a) of the Internal Revenue Code of 1954.

§ 1.9000–2 Effect of repeal in general.

(a) Section 452 (relating to prepaid income) and section 462 (relating to reserves for estimated expenses) of the Internal Revenue Code of 1954 were repealed by the Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 134), with respect to all years subject to such Code. The effect of the repeal will generally be to increase the tax liability of taxpayers who elected to adopt the methods of accounting provided by sections 452 and 462. References to sections of law in §§ 1.9000–2 to 1.9000–8, inclusive, are references to the Internal Revenue Code of 1954 unless otherwise specified.

(b) The Act of June 15, 1955, provides that if the amount of any tax is increased by the repeal of sections 452 and 462 and if the last date prescribed for the payment of such tax (or any installment thereof) is before December 15, 1955, then the taxpayer shall on or before such date file a statement as prescribed in § 1.9000–3. The last date prescribed for payment for this purpose shall be determined without regard to any extensions of time and without regard to the provisions of the Act of June 15, 1955.

§ 1.9000–3 Requirement of statement showing increase in tax liability.

(a) *Returns filed before June 15, 1955.* Where a return reflecting an election under section 452 or 462 was filed before June 15, 1955, the taxpayer must file on or before December 15, 1955, a statement on Form 2175 showing the increase in tax liability resulting from the repeal of sections 452 and 462. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation X filed its income tax return for the calendar year 1954 on March 15, 1955, and elected under section 6152 to pay the unpaid amount of the tax shown thereon in two equal installments. Such installment payments are due on March 15, 1955, and June 15, 1955, respectively. The corporation elected to compute its tax for such taxable year under the methods of accounting provided by sections 452 and 462. Corporation X's tax liability is increased by reason of the enactment of Public Law 74, and since the last date prescribed for paying its tax expires before December 15, 1955, it is required to submit the prescribed statement on or before December 15, 1955, showing its increase in tax liability.

(b) *Returns filed on or after June 15, 1955.* A taxpayer filing a return on or after June 15, 1955, for a taxable year ending on or before such date, may elect to apply the accounting methods provided in sections 452 and 462. The election may be exercised by either of the following methods:

(1) By computing the tax liability shown on such return as though the provisions of sections 452 and 462 had not been repealed. In such a case, the taxpayer must file on or before December 15, 1955, a statement on Form 2175 showing the increase in tax liability resulting from the repeal of sections 452 and 462.

(2) By computing his tax liability without regard to sections 452 and 462. In this case, Form 2175 must be filed with the return. However, taxable income and the tax liability computed with the application of sections 452 and 462 shall be shown on lines 8 and 14, respectively, of the form in lieu of the amounts otherwise called for on those lines.

If a taxpayer does not make an election to have the provisions of sections 452 and 462 apply, the savings provisions of section 4 of the Act of June 15, 1955, are not applicable.

(c) *Taxable years ending after June 15, 1955.* A taxpayer having a taxable year ending after June 15, 1955, may not elect to apply the methods of accounting prescribed in sections 452 and 462 in computing taxable income for such taxable year. Such a taxpayer must file his return and pay the tax as if such sections had not been enacted.

(d) *Other situations requiring statements.* (1) A person who made an election under section 452 or 462 but whose tax liability was not increased by reason of the enactment of the Act of June 15, 1955, is nevertheless required to file a statement on Form 2175 if his gross income is increased or his deductions are decreased as the result of the repeal of sections 452 and 462. A partnership which makes an election under such sections must file such a statement. In addition, a partner, stockholder, distributee, etc. (whether or not such person made an election under section 452 or 462), shall file a statement showing any increase in his tax liability resulting from the effects of the repeal on the gross income or deductions of any person mentioned in the previous sentences of this subparagraph.

(2) A statement shall also be filed for a taxable year, other than a year to which an election under section 452 or 462 is applicable, if the repeal of such sections increases the tax liability of such year. Thus, a statement must be filed for any taxable year to which a net operating loss is carried from a year to which an election under section 452 or 462 is applicable, provided that the repeal of such sections affects the amount of the tax liability for the year to which such loss is carried. A separate statement must also be filed for a year in which there is a net operating loss which is changed by reason of the repeal of sections 452 and 462. Where there is a short taxable year involved, a taxpayer may have two taxable years to which elections under sections 452 and 462 are applicable and, in such a case, a statement, on Form 2175, must be filed for each such year.

§ 1.9000–4 Form and content of statement.

(a) *Information to be shown.* The statement shall be filed on Form 2175 which may be obtained from district directors. It shall be filed with the district director for the internal revenue district in which the return was filed. The statement shall be prepared in accordance with the instructions contained thereon and shall show the following information:

(1) The name and address of the taxpayer.

(2) The amounts of each type of income deferred under section 452,

(3) The amount of the addition to each reserve deducted under section 462,

(4) The taxable income and the tax liability of the taxpayer computed with the application of sections 452 and 462,

(5) The taxable income and the tax liability of the taxpayer computed without the application of sections 452 and 462,

(6) The details of the recomputation of taxable income and tax liability, including any changes in other items of income, deductions, and credits resulting from the repeal of sections 452 and 462, and

(7) If self-employment tax is increased, the computations and information required on page 3 of Schedule C, Form 1040.

(b) *Procedure for recomputing tax liability.* In determining the taxable income and the tax liability computed without the application of sections 452 and 462, such items as vacation pay and prepaid subscription income shall be reported under the law and regulations applicable to the taxable year as if such sections had not been enacted. The tax liability for the year shall be recomputed by restoring to taxable income the amount of income deferred under section 452 and the amount of the deduction taken under section 462. Other deductions or credits affected by such changes in taxable income shall be adjusted. For example, if the deduction for contributions allowed for the taxable year was limited under section 170 (b), the amount of such deduction shall be recomputed, giving effect to the increase in adjusted gross income or taxable income, as the case may be, by reason of the adjustments required by the repeal of sections 452 and 462.

§ 1.9000–5 Effect of filing statement.

(a) *Years other than years affected by a net operating loss carryback.* If the taxpayer files a timely statement in accordance with the provisions of § 1.9000–3, the amount of the increase in tax shown on such statement for a taxable year shall, except as provided in paragraph (b) of this section, be considered for all purposes of the Code, as tax shown on the return for such year. In general, such increase shall be assessed and collected in the same manner as if it had been tax shown on the return as originally filed. The provisions of this paragraph may be illustrated by the following example:

Example. A taxpayer filed his return showing a tax liability computed under the methods of accounting provided by sections 452 and 462 as $1,000 and filed the statement in accordance with § 1.9000–3 showing an increase in tax liability of $200. The tax computed as though sections 452 and 462 had not been enacted is $1,200, and the difference of $200 is the increase in the tax attributable to the repeal of sections 452 and 462. This increase is considered to be tax shown on the return for such taxable year. Additions to the tax for fraud or negligence under section 6653 will be determined by reference to $1,200 (that is, $1,000 plus $200) as the tax shown on the return.

(b) *Years affected by a net operating loss carryback.* In the case of a year which is affected by a net operating loss carryback from a year to which an election under section 452 or 462 applies, that portion of the amount of increase in tax shown on the statement for the year to which the loss is carried back which is attributable to a decrease in such net operating loss shall not be treated as tax shown on the return.

§ 1.9000–6 Provisions for the waiver of interest.

(a) *In general.* If the statement is filed in accordance with § 1.9000–3 and if that portion of the increase in tax which is due before December 15, 1955 (without regard to any extension of time for payment and without regard to the provisions of §§ 1.9000–2 to 1.9000–8, inclusive), is paid in full on or before such date, then no interest shall be due with respect to that amount. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation M's return for the calendar year 1954 was filed on March 15, 1955, and the tax liability shown thereon was paid in equal installments on March 15, 1955, and June 15, 1955. M filed a statement on December 15, 1955, showing the increase in its tax liability resulting from the repeal of sections 452 and 462 and paid at that time the increase in tax shown thereon. No interest will be imposed with respect to the amount of such payment.

Interest shall be computed under the applicable provisions of the internal revenue laws on any portion of the increase in tax shown on the statement which is due after December 15, 1955, and which is not paid when due.

(b) *Limitation on application of waiver.* The provisions of paragraph (a) of this section shall not apply to any portion of the increase in tax shown on the statement if such increase reflects an amount in excess of that attributable solely to the repeal of sections 452 and 462, i. e., is attributable in whole or in part to excessive or unwarranted deferrals or accruals under section 452 or 462, as the case may be, in computing the tax liability with the application of such sections. Notwithstanding the preceding sentence, paragraph (a) of this section shall be applicable if the taxpayer can show that the tax liability as computed with the application of sections 452 and 462 is based upon a reasonable interpretation and application of such sections as they existed prior to repeal. If the taxpayer complied with the provisions of the regulations under sections 452 and 462 in computing the tax liability with the application of such sections, he will be regarded as having reasonably interpreted and applied sections 452 and 462. In this regard, it is not essential that the taxpayer submit with his return the detailed information required by

such regulations in support of the deduction claimed under section 462, but such information shall be supplied at the request of the Commissioner.

(c) *Interest for periods prior to June 16, 1955.* No interest shall be imposed with respect to any increase in tax resulting solely from the repeal of sections 452 and 462 for any period prior to June 16, 1955 (the day after the date of the enactment of the Act of June 15, 1955). The preceding sentence does not apply to that part of any increase in tax which is due to the improper application of sections 452 and 462. The provisions of this paragraph shall not apply to interest imposed under section 3779 of the Internal Revenue Code of 1939. (See paragraph (d) of this section.)

(d) *Amounts deferred by corporations expecting carrybacks.* Interest shall be imposed at the rate of 6 percent on so much of the amount of tax deferred under section 3779 of the Internal Revenue Code of 1939 as is not satisfied within the meaning of section 3779 (i) (1), notwithstanding the fact that a greater amount would have been satisfied, had sections 452 and 462 not been repealed. Interest will be imposed at such rate until the amount not so satisfied is paid.

§ 1.9000–7 Provisions for estimated tax.

(a) *Additions to tax under section 294(d) of the Internal Revenue Code of 1939.* Any addition to the tax under section 294(d) (relating to estimated tax) of the Internal Revenue Code of 1939 shall be computed as if the tax for the year for which the estimate was made were computed with sections 452 and 462 still applicable to such taxable year. For the purpose of the preceding sentence, it is not necessary for the taxpayer actually to have made an election under section 452 or 462; it is only necessary for the taxpayer to have taken such sections into account in estimating its tax liability for the year. Thus, if in determining the amount of estimated tax, the taxpayer computed his estimated tax liability by applying those sections, that portion of any additions to tax under section 294 (d) resulting from the repeal of sections 452 and 462 shall be disregarded.

(b) *Additions to tax under section 6654.* In the case of an underpayment of estimated tax, any additions to the tax under section 6654, with respect to installments due before December 15, 1955, shall be computed without regard to any increase in tax resulting from the repeal of sections 452 and 462. Any additions to the tax with respect to installments due on or after December 15, 1955, shall be imposed in accordance with the applicable provisions of the Code, and as though sections 452 and 462 had not been enacted. Thus, a taxpayer whose declaration of estimated tax was based upon an estimate of his taxable income for the year of the estimate which was determined by taking sections 452 and 462 into account, must file an amended declaration on or before the due date of the next installment of estimated tax due on or after December 15, 1955. Such amended declaration shall reflect an estimate of the tax without the application of such sections. If the taxpayer bases his estimate on the tax for the preceding taxable year under section 6654 (d) (1) (A), an amended declaration must be filed on or before the due date of the next installment due on or after December 15, 1955, if the tax for the preceding taxable year is increased as the result of the repeal of sections 452 and 462. Similarly, if the taxpayer bases his estimate on the tax computed under section 6654 (d) (1) (B), he must file an amended declaration on or before the due date of the next installment due on or after December 15, 1955, taking into account the repeal of sections 452 and 462 with respect to the preceding taxable year. Any increase in estimated tax shown on an amended declaration filed in accordance with this paragraph must be paid in accordance with section 6153 (c).

(c) *Estimated tax of corporations.* Corporations required to file a declaration of estimated tax under section 6016 for taxable years ending on and after December 31, 1955, shall estimate their tax liability for such year as if sections 452 and 462 had not been enacted. Thus, if the corporation bases its estimated tax liability under section 6655 (d) (1) or (2) on its operations for the preceding taxable year, the effect of the repeal of sections 452 and 462 with respect to such year must be taken into account.

§ 1.9000–8 Extension of time for making certain payments.

(a) *Time for payment specified in Code.* (1) If the treatment of any payment (including its allowance as a deduction or otherwise) is dependent upon the making of a payment within a period of time specified in the Code the period within which the payment is to be made is extended where the amount to be paid is increased by reason of the repeal of sections 452 and 462: *Provided,* That:

(i) The taxpayer, because of a preexisting obligation, is required to make a payment or an additional payment to another person by reason of such repeal;

(ii) The deductibility of the payment or additional payment is contingent upon its being made within a period prescribed by the Code, which period expires after the close of the taxable year; and

(iii) The payment or additional payment is made on or before December 15, 1955.

If the foregoing conditions are met, the payment or additional payment will be treated as having been made within the time specified in the Code, and, subject to any other conditions in the Code, it shall be deductible for the year to which it relates. The provision of this paragraph may be illustrated by the following examples:

Example 1. Section 267 (relating to losses, expenses and interest between related taxpayers) applies to amounts accrued by taxpayer A for salary payable to B. For the calendar year 1954, A is obligated to pay B a salary equal to 5 percent of A's taxable income for the taxable year. The amount accrued as salary payable to B for 1954 is $5,000 with the taxable income reflecting the application of section 462. As a result of the repeal of section 462 the salary payable to B for 1954 is increased to $6,000. The additional $1,000 is paid to B on December 15, 1955. In recomputing A's tax liability for 1954 the additional deduction of $1,000 for salary payable to B will be treated as having been made within two and one-half months after the close of the taxable year and will be deductible in that year.

Example 2. On March 1, 1955, Corporation X, a calendar year taxpayer using the accrual method of accounting, makes a payment described in section 404 (a) (6) (relating to contributions to an employees' trust) of $10,000 which is accrued for 1954 and is determined on the basis of the amount of taxable income for that year. The taxpayer filed its return on March 15, 1955. By reason of the repeal of section 462, X's taxable income is increased so that it is required to make an additional contribution of $2,000 to the employees' trust. The additional payment is made on December 15, 1955. For purposes of recomputing X's tax liability for 1954, this additional payment is deemed to have been made on the last day of 1954.

(2) The time for inclusion in the taxable income of the payee of any additional payment of the type described in subparagraph (1) of this paragraph, shall be determined without regard to section 4(c)(3) of the Act of June 15, 1955, and §§ 1.9000–2 to 1.9000–8, inclusive.

(b) *Dividends paid under section 561.* under section 4(c)(4) of the Act of June 15, 1955, the period during which distributions may be recognized as dividends paid under section 561 for a taxable year to which section 452 or 462 apply may be extended under the conditions set forth below.

(1) *Accumulated earnings tax or personal holding company tax.* In the case of the accumulated earnings tax or the personal holding company tax, if:

(i) The income of a corporation is increased for a taxable year by reason of the repeal of sections 452 and 462 so that it would become liable for the tax (or an increase in the tax) imposed on accumulated earnings or personal holding companies unless additional dividends are distributed;

(ii) The corporation distributes dividends to its stockholders after the 15th day of the 3d month following the close of its taxable year and on or before December 15, 1955, which dividends are attributable to an increase in its accumulated taxable income or undistributed personal holding company income, as the case may be, resulting from the repeal of sections 452 and 462, and

(iii) The corporation elects in its statement, submitted under § 1.9000–3, to have the provisions of section 4 (c) (4) of the Act of June 15, 1955, apply—

then such dividends shall be treated as having been paid on the last day of the taxable year to which the statement applies.

(2) *Regulated investment companies.* In the case of a regulated investment company taxable under section 852, if—

(i) The taxable income of the regulated investment company is increased by reason of the repeal of sections 452 and 462 (without regard to any deduction for dividends paid as provided for in this subparagraph);

(ii) The company distributes dividends to its stockholders after the 15th

day of the 3rd month following the close of its taxable year and on or before December 15, 1955, which dividends are attributable to an increase in its investment company income resulting from the repeal of sections 452 and 462; and

(iii) The company elects in its statement, submitted under § 1.9000–3, to have the provisions of section 4 (c) (4) of the Act of June 15, 1955, apply—

then such dividends are to be treated as having been paid on the last day of the taxable year to which the statement applies. The dividends paid are to be determined under this subparagraph without regard to the provisions of section 855.

(3) *Related provisions.* An election made under subparagraph (1) or (2) of this paragraph is irrevocable. The time for inclusion in the taxable income of the distributees of any distributions of the type described in subparagraph (1) or (2) of this paragraph shall be determined without regard to section 4(c)(4) of the Act of June 15, 1955, and §§ 1.9000–2 to 1.9000–8, inclusive.

RETIREMENT-STRAIGHT LINE ADJUSTMENT ACT OF 1958

§ 1.9001 Statutory provisions; Retirement-Straight Line Adjustment Act of 1958.

Section 94 of the Technical Amendments Act of 1958 (72 Stat. 1669) provides as follows:

SEC. 94. *Change from retirement to straight line method of computing depreciation in certain cases*—(a) *Short title.* This section may be cited as the "Retirement-Straight Line Adjustment Act of 1958".

(b) *Making of election.* Any taxpayer who held retirement-straight line property on his 1956 adjustment date may elect to have this section apply. Such an election shall be made at such time and in such manner as the Secretary shall prescribe. Any election under this section shall be irrevocable and shall apply to all retirement-straight line property as hereinafter provided in this section (including such property for periods when held by predecessors of the taxpayer).

(c) *Retirement-straight line property defined.* For purposes of this section, the term "retirement-straight line property" means any property of a kind or class with respect to which the taxpayer or a predecessor (under the terms and conditions prescribed for him by the Commissioner) for any taxable year beginning after December 31, 1940, and before January 1, 1956, changed from the retirement to the straight line method of computing the allowance of deductions for depreciation.

(d) *Basis adjustments as of 1956 adjustment date.* If the taxpayer has made an election under this section, then in determining the adjusted basis on his 1956 adjustment date of all retirement-straight line property held by the taxpayer, in lieu of the adjustments for depreciation provided in section 1016(a) (2) and (3) of the Internal Revenue Code of 1954, the following adjustments shall be made (effective as of his 1956 adjustment date) in respect of all periods before the 1956 adjustment date:

(1) *Depreciation sustained before March 1, 1913.* For depreciation sustained before March 1, 1913, on retirement-straight line property held by the taxpayer or a predecessor on such date for which cost was or is claimed as basis and which either—

(A) *Retired before changeover.* Was retired by the taxpayer or a predecessor before the changeover date, but only if (i) a deduction was allowed in computing net income by reason of such retirement, and (ii) such deduction was computed on the basis of cost without adjustment for depreciation sustained before March 1, 1913. In the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment under this subparagraph shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, which resulted (by reason of the deduction so allowed) in a reduction in taxes under the Internal Revenue Code of 1954 or prior income, war-profits, or excess-profits tax laws.

(B) *Held on changeover date.* Was held by the taxpayer or a predecessor on the changeover date. This subparagraph shall not apply to property to which paragraph (2) applies.

The adjustment determined under this paragraph shall be allocated (in the manner prescribed by the Secretary) among all retirement-straight line property held by the taxpayer on his 1956 adjustment date.

(2) *Property disposed of after changeover and before 1956 adjustment date.* For that portion of the reserve prescribed by the Commissioner in connection with the changeover which was applicable to property—

(A) Sold, or

(B) With respect to which a deduction was allowed for Federal income tax purposes by reason of casualty or "abnormal" retirement in the nature of special obsolescence,

if such sale occurred in, or such deduction was allowed for, a period on or after the changeover date and before the taxpayer's 1956 adjustment date.

(3) *Depreciation allowable from changeover to 1956 adjustment date.* For depreciation allowable, under the terms and conditions prescribed by the Commissioner in connection with the changeover, for all periods on and after the changeover date and before the taxpayer's 1956 adjustment date.

This subsection shall apply only with respect to taxable years beginning after December 31, 1955.

(e) *Effect on period from changeover to 1956 adjustment date.* If the taxpayer has made an election under this section, then in determining the adjusted basis of any retirement-straight line property as of any time on or after the changeover date and before the taxpayer's 1956 adjustment date, in lieu of the adjustments for depreciation provided in section 1016(a) (2) and (3) of the Internal Revenue Code of 1954 and the corresponding provisions of prior revenue laws, the following adjustments shall be made:

(1) *For prescribed reserve.* For the amount of the reserve prescribed by the Commissioner in connection with the changeover.

(2) *For allowable depreciation.* For the depreciation allowable under the terms and conditions prescribed by the Commissioner in connection with the changeover.

This subsection shall not apply in determining adjusted basis for purposes of section 437(c) of the Internal Revenue Code of 1939. This subsection shall apply only with respect to taxable years beginning on or after the changeover date and before the taxpayer's 1956 adjustment date.

(f) *Equity invested capital, etc.* If an election is made under this section, then (notwithstanding the terms and conditions prescribed by the Commissioner in connection with the changeover)—

(1) *Equity invested capital.* In determining equity invested capital under sections 458 and 718 of the Internal Revenue Code of 1939, accumulated earnings and profits as of the changeover date, and as of the beginning of each taxable year thereafter, shall be reduced by the depreciation sustained before March 1, 1913, as computed under subsection (d)(1)(B); and

(2) *Definition of equity capital.* In determining the adjusted basis of assets for the purpose of section 437(c) of the Internal Revenue Code of 1939 (and in addition to any other adjustments required by such Code), the basis shall be reduced by depreciation sustained before March 1, 1913 (as computed under subsection (d)), together with any depreciation allowable under subsection (e)(2) for any period before the year for which the excess profits credit is being computed.

(g) *Definitions.* For purposes of this section—

(1) *Depreciation.* The term "depreciation" means exhaustion, wear and tear, and obsolescence.

(2) *Changeover.* The term "changeover" means a change from the retirement to the straight line method of computing the allowance of deductions for depreciation.

(3) *Changeover date.* The term "changeover date" means the first day of the first taxable year for which the changeover was effective.

(4) *1956 adjustment date.* The term "1956 adjustment date" means, in the case of any taxpayer, the first day of his first taxable year beginning after December 31, 1955.

(5) *Predecessor.* The term "predecessor" means any person from whom property of a kind or class to which this section refers was acquired, if the basis of such property is determined by reference to its basis in the hands of such person. Where a series of transfers of property has occurred and where in each instance the basis of the property was determined by reference to its basis in the hands of the prior holder, the term includes each such prior holder.

(6) The term "Secretary" means the Secretary of the Treasury or his delegate.

(7) The term "Commissioner" means the Commissioner of Internal Revenue.

§ 1.9001–1 Change from retirement to straight-line method of computing depreciation.

(a) *In general.* The Retirement-Straight Line Adjustment Act of 1958 (72 Stat. 1669), which is contained in section 94 of the Technical Amendments Act of 1958, approved September 2, 1958, provides various adjustments to be made by certain railroads which changed from the retirement to the straight-line method of computing the allowance of deductions for the depreciation of those roadway assets which are defined in this section as retirement-straight line property. The adjustments are available to all eligible taxpayers who make an irrevocable election to have the provisions of the Retirement-Straight Line Adjustment Act of 1958 apply. This election shall be made at the time and in the manner prescribed by this section. If an election is made in accordance with this section, then the provisions of the Act and of §§ 1.9001 to 1.9001–4, inclusive, shall apply. An election made in accordance with this section shall not be considered a change in accounting method for purposes of section 481 of the Code.

(b) *Making of election.* (1) Subsection (b) of the Act provides that any taxpayer who held retirement-straight line property on its 1956 adjustment date may elect to have the provisions of the Act apply. The election shall be irrevocable and shall apply to all retirement-

straight line property, including such property for periods when held by predecessors of the taxpayer.

(2) An election may be made in accordance with the provisions of this section even though the taxpayer has, at the time of election, litigated some or all of the issues covered by the provisions of the Act and has received from the courts a determination which is less favorable to the taxpayer than the treatment provided by the Act. Once an election has been made in accordance with the provisions of this section, the taxpayer may not receive the benefit of more favorable treatment, as a result of litigation, than that provided by the Act on the issues involved.

(3) The election to have the provisions of the Act apply shall be made by filing a statement to that effect, on or before January 11, 1960, with the district director for the internal revenue district in which the taxpayer's income tax return for its first taxable year beginning after December 31, 1955, was filed. A copy of this statement shall be filed with any amended return, or claim for refund, made under the Act.

(c) *Definitions.* For purposes of the Act and §§ 1.9001 to 1.9001–4, inclusive—

(1) *The Act.* The term "the Act" means the Retirement-Straight Line Adjustment Act of 1958, as contained in section 94 of the Technical Amendments Act of 1958 (72 Stat. 1669).

(2) *Commissioner.* The term "Commissioner" means the Commissioner of Internal Revenue.

(3) *Retirement-straight line property.* The term "retirement-straight line property" means any property of a kind or class with respect to which the taxpayer (or a predecessor of the taxpayer) changed, pursuant to the terms and conditions prescribed for it by the Commissioner, from the retirement to the straight-line method of computing the allowance for any taxable year beginning after December 31, 1940, and before January 1, 1956, of deductions for depreciation. The term does not include any specific property which has always been properly accounted for in accordance with the straight-line method of computing the depreciation allowances or which, under the terms-letter, was permitted or required to be accounted for under the retirement method.

(4) *Depreciation.* The term "depreciation" means exhaustion, wear and tear, and obsolescence.

(5) *Predecessor.* The term "predecessor" means any person from whom property of a kind or class to which the Act refers was acquired, if the basis of such property is determined by reference to its basis in the hands of such person. Where a series of transfers of property has occurred and where in each instance the basis of the property was determined by reference to its basis in the hands of the prior holder, the term includes each such prior holder.

(6) *Changeover.* The term "changeover" means a change from the retirement to the straight-line method of computing the allowance of deductions for depreciation.

(7) *Changeover date.* The term "changeover date" means the first day of the first taxable year for which the changeover was effective.

(8) *1956 adjustment date.* The term "1956 adjustment date" means, in the case of any taxpayer, the first day of its first taxable year beginning after December 31, 1955.

(9) *Terms-letter.* The term "terms-letter" means the terms and conditions prescribed by the Commissioner in connection with the changeover.

(10) *Terms-letter reserve.* The term "terms-letter reserve" means the reserve for depreciation prescribed by the Commissioner in connection with the changeover.

(11) *Depreciation sustained before March 1, 1913.* The term "depreciation sustained before March 1, 1913" may be construed to mean, to the extent that it is impossible to determine the actual amount of such depreciation from the books and records, that amount which is obtained by (i) deducting the "cost of reproduction new less depreciation" from the "cost of reproduction new", as ascertained as of the valuation date by the Interstate Commerce Commission under the provisions of section 19a of part I of the Interstate Commerce Act (49 U.S.C. 19a), and then (ii) making such retroactive adjustments to the remainder as are required, in the opinion of the Commissioner of Internal Revenue, to properly reflect the depreciation sustained before March 1, 1913. For this purpose, any retirement-straight line property held on March 1, 1913, and retired on or before the valuation date shall be taken into account.

§ 1.9001–2 Basis adjustments for taxable years beginning on or after 1956 adjustment date.

(a) *In general.* Subsection (d) of the Act provides the basis adjustments required to be made by the taxpayer as of the 1956 adjustment date in respect of all periods before that date in order to determine the adjusted basis of all retirement-straight line property held by the taxpayer on that date. This adjusted basis on the 1956 adjustment date shall be used by the taxpayer for all purposes of the Code for any taxable year beginning after December 31, 1955. In order to arrive at the adjusted basis on the 1956 adjustment date, the taxpayer shall start with the unadjusted basis of all retirement-straight line property held on the changeover date by the taxpayer or a predecessor and shall, with respect to both the asset and reserve accounts, (1) make the adjustments prescribed by this section and subsection (d) of the Act and (2) also make those adjustments required, in accordance with the method of accounting regularly used, for those additions, retirements, and other dispositions of property which occurred on or after the changeover date and before the taxpayer's 1956 adjustment date. For an illustration of adjustments required in accordance with the method of accounting regularly used, see paragraph (e)(3) of this section. The adjustments required by subsection (d) of the Act shall be made in lieu of the adjustments for depreciation otherwise required by section 1016(a) (2) and (3) of the Code. The adjustments required by subsection (d) of the Act are set forth in paragraphs (b), (c), and (d) of this section.

(b) *Adjustment for depreciation sustained before March 1, 1913*—(1) *In general.* Subsection (d)(1) of the Act requires an adjustment to be made as of the 1956 adjustment date for depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was either (i) retired before the changeover date by the taxpayer or a predecessor or (ii) held on the changeover date by the taxpayer or a predecessor. This adjustment for depreciation sustained before March 1, 1913, shall be made in accordance with the conditions and limitations described in subparagraphs (2) and (3) of this paragraph and shall be allocated, in the manner prescribed in subparagraph (4) of this paragraph, among all retirement-straight line property held by the taxpayer on its 1956 adjustment date. The term "cost", when used in this paragraph with reference to the basis of property, shall be construed to mean the amount paid for the property or, if that amount could not be determined, then such other amount as was accepted by the Commissioner as "cost" for basis purposes.

(2) *Depreciation sustained on property retired before the changeover date.* Pursuant to subsection (d)(1)(A) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was claimed as the basis and which was retired before the changeover date by the taxpayer or a predecessor, except that—

(i) The adjustment shall be made only if a deduction was allowed in computing net income by reason of the retirement and the deduction so allowed was computed on the basis of the cost of the property unadjusted for depreciation sustained before March 1, 1913, and

(ii) In the case of any such property retired during any taxable year beginning after December 31, 1929, the adjustment shall not exceed that portion of the amount attributable to depreciation sustained before March 1, 1913, which resulted, by reason of the deduction so allowed, in a reduction of taxes under the Code or under prior income, war-profits or excess-profits tax laws.

(3) *Depreciation sustained on property held on the changeover date.* Pursuant to subsection (d)(1)(B) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was

held on the changeover date by the taxpayer or a predecessor. This subparagraph shall not apply, however, to any such property which (i) was disposed of on or after the changeover date by reason of sale, casualty, or abnormal retirement in the nature of special obsolescence, and (ii) is property to which paragraph (c) of this section and subsection (d)(2) of the Act apply.

(4) *Manner of allocating adjustment.* Pursuant to subsection (d)(1) of the Act, the amount of the adjustment required under this paragraph for depreciation sustained before March 1, 1913, which is attributable to a particular kind or class of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made with respect to that kind or class of such property. If the adjustment required under this paragraph for depreciation sustained before March 1, 1913, is attributable to retirement-straight property of a particular kind or class no longer held by the taxpayer on its 1956 adjustment date, then the part of the adjustment to be allocated to any retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be that amount which bears the same ratio to the adjustment as the unadjusted basis of the property so held bears to the entire unadjusted basis of all retirement-straight line property held by the taxpayer on its 1956 adjustment date.

(c) *Adjustment for part of terms-letter reserve applicable to property disposed of on or after changeover date and before 1956 adjustment date.* Pursuant to subsection (d)(2) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for that part of the terms-letter reserve which was applicable to any retirement-straight line property disposed of by sale, casualty, or abnormal retirement in the nature of special obsolescence, but only if the sale occurred in, or a deduction by reason of such casualty or abnormal retirement was allowed for Federal income-tax purposes for, a period on or after the changeover date and before the taxpayer's 1956 adjustment date. This paragraph shall apply even though, in computing the adjusted basis of the property for purposes of determining gain or loss on the sale, casualty, or abnormal retirement, the basis of the retirement-straight line property was not reduced by the part of the terms-letter reserve applicable to the property. If necessary, the adjustment required by this paragraph shall be allocated, in the manner prescribed in paragraph (b)(4) of this section, among all retirement-straight line property held by the taxpayer on its 1956 adjustment date.

(d) *Adjustment for depreciation allowable under the terms-letter for periods on and after the changeover date and before the 1956 adjustment date.* Pursuant to subsection (d)(3) of the Act, an adjustment to the basis of retirement-straight line property held by the taxpayer on its 1956 adjustment date shall be made as of that date for the entire amount of depreciation allowable under the terms-letter for all periods on and after the changeover date and before the taxpayer's 1956 adjustment date. This adjustment shall include all such depreciation allowable with respect to any retirement-straight line property which was disposed of on or after the changeover date and before the 1956 adjustment date.

(e) *Illustration of basis adjustments required for taxable years beginning on or after the 1956 adjustment date.* The application of this section may be illustrated by the following example, which is based upon the assumption that multiple asset accounts are used:

Example. (1) Assume that on its changeover date, January 1, 1943, the taxpayer or its predecessor held retirement-straight line property with an unadjusted cost basis of $10,000. The terms-letter reserve established as of January 1, 1943, with respect to such property was $3,000. Depreciation sustained before March 1, 1913, on retirement-straight line property held on that date by the taxpayer or its predecessor, for which cost was or is claimed as basis, amounts to $800. Of this total depreciation sustained before March 1, 1913, $200 is attributable to retirement-straight line property retired before January 1, 1943, under circumstances requiring the adjustment under paragraph (b)(2) of this section, and $600 is attributable to retirement-straight line property held on January 1, 1943, by the taxpayer or its predecessor. On December 31, 1954, retirement-straight line property costing $1,500 was permanently retired under circumstances giving rise to an abnormal retirement in the nature of special obsolescence. The terms-letter reserve applicable to this retired property was $450, of which $120 represents depreciation sustained before March 1, 1913. On December 31, 1954, retirement-straight line property costing $1,000 was also permanently retired under circumstances giving rise to a normal retirement. None of the property retired on December 31, 1954, had any market or salvage value on that date. Depreciation allowable under the terms-letter on retirement-straight line property for all periods on and after January 1, 1943, and before January 1, 1956 (the taxpayer's 1956 adjustment date), amounts to $2,155, of which $345 is applicable to the property retired as an abnormal retirement.

(2) The reserve for depreciation as of January 1, 1956, contains a credit balance of $3,360, determined as follows but without regard to the Act:

(i) Credits to reserve:		
Terms-letter reserve as of January 1, 1943		$3,000
Depreciation allowable under terms-letter from January 1, 1943, to December 31, 1955		2,155
Balance		5,155
(ii) Charges to reserve:		
Part of terms-letter reserve applicable to property abnormally retired	$450	
Depreciation applicable to property abnormally retired and allowable from January 1, 1943, to December 31, 1954	345	
Adjustment for normal retirement	1,000	
		1,795
(iii) Balance as of January 1, 1956		3,360

(3) The adjusted basis on January 1, 1956, of the retirement-straight line property held by the taxpayer on that date is $6,010, determined as follows and in accordance with this section:

(i) Asset account:		
Unadjusted cost on January 1, 1943		$10,000
Less:		
Adjustment for abnormal retirement	$1,500	
Adjustment for normal retirement	1,000	
		2,500
Balance as of January 1, 1956		7,500
(ii) Credits to reserve for depreciation:		
Depreciation sustained before March 1, 1913, on—		
Property retired before January 1, 1943		$200
Property held on January 1, 1943	$600	
Less part of such depreciation sustained on property abnormally retired on December 31, 1954	120	
		480
Part of terms-letter reserve applicable to property abnormally retired on December 31, 1954 (including $120 depreciation sustained before March 1, 1913)		450
Depreciation allowable under terms-letter from January 1, 1943, to December 31, 1955		2,155
Total credits		3,285
(iii) Charges to reserve for depreciation:		
Part of terms-letter reserve applicable to property abnormally retired		$450
Depreciation applicable to property abnormally retired and allowable from January 1, 1943, to December 31, 1954		345
Adjustment for normal retirement		1,000
Total charges		1,795
(iv) Balance in reserve for depreciation:		
Total credits		$3,285
Total charges		1,795
Balance as of January 1, 1956		1,490
(v) Adjusted basis of property:		
Balance in asset account		$7,500
Balance in reserve for depreciation		1,490
Adjusted basis as of January 1, 1956		6,010

(4) The following adjustments to the reserve determined under subparagraph (2) of this paragraph may be made in order to arrive at the reserve determined under subparagraph (3)(iv) of this paragraph:

(i) Credit balance in reserve, as determined under subparagraph (2) of this paragraph		$3,360
(ii) Credit adjustments:		
Depreciation sustained before March 1, 1913, on—		
Property retired before January 1, 1943	$200	
Property held on January 1, 1943	480	
Part of terms-letter reserve applicable to property abnormally retired on December 31, 1954	450	
		1,130
Balance		4,490
(iii) Debit adjustment:		
Terms-letter reserve as of January 1, 1943		3,000
(iv) Credit Balance in reserve, as determined under subparagraph (3)(iv) of this paragraph		1,490

(5) The $6,010 adjusted basis as of January 1, 1956, of the retirement-straight line property held by the taxpayer on that date is to be recovered over the estimated remaining useful life of that property. The remaining useful life of the property will be reviewed regularly, and appropriate adjustments in the rates will be made as necessary in order to spread the remaining cost less estimated salvage over the estimated remaining useful life of the property. See § 1.167(a)–1.

§ 1.9001–3 Basis adjustments for taxable years between changeover date and 1956 adjustment date.

(a) *In general.* (1) Subsection (e) of the Act provides the adjustments required to be made in determining the adjusted basis of any retirement-straight line property as of any time on or after the changeover date and before the taxpayer's 1956 adjustment date. This adjusted basis shall be used for all purposes of the Internal Revenue Code of 1939 and the Internal Revenue Code of 1954 for taxable years beginning on or after the changeover date and before the taxpayer's 1956 adjustment date, except as provided in subparagraph (4) of this paragraph. The adjustments so required, which are set forth in paragraphs (b) and (c) of this section, shall not be used in determining the adjusted basis of property for taxable years beginning before the changeover date or on or after the taxpayer's 1956 adjustment date.

(2) In order to arrive at the adjusted basis as of any specific date occurring on or after the changeover date and before the 1956 adjustment date, the taxpayer shall start with the unadjusted basis of all retirement-straight line property held on the changeover date by the taxpayer or its predecessor and shall, as of that specific date and with respect to both the asset and reserve accounts, (i) make the adjustments prescribed by this section and subsection (e) of the Act and (ii) also make those adjustments required, in accordance with the method of accounting regularly used, for additions, retirements, and other dispositions of property. For an illustration of adjustments required in accordance with the method of accounting regularly used, see the example in paragraph (d) of this section.

(3) The adjustments required by subsection (e) of the Act shall be made in lieu of the adjustments for depreciation otherwise required by section 1016(a)(2) and (3) of the Code and by the corresponding provisions of prior revenue laws.

(4) Although this section, and subsection (e) of the Act, shall apply in determining the excess-profits tax, they shall not apply in determining adjusted basis for the purpose of computing equity capital for any day under section 437(c) (relating to the Excess Profits Tax Act of 1950) (64 Stat. 1137) of the Internal Revenue Code of 1939. For the adjustments to be made in computing equity capital under such section, see paragraph (c) of § 1.9001–4.

(b) *Adjustment for terms-letter reserve.* Pursuant to subsection (e)(1) of the Act, the basis of any retirement-straight line property shall be adjusted, as of any specific applicable date occurring on or after the changeover date and before the 1956 adjustment date, for the amount of the terms-letter reserve applicable to such property.

(c) *Adjustment for depreciation allowable under the terms-letter.* Pursuant to subsection (e)(2) of the Act, the basis of any retirement-straight line property shall be adjusted, as of any specific applicable date occurring on or after the changeover date and before the 1956 adjustment date, for depreciation applicable to such property and allowable under the terms-letter.

(d) *Illustration of basis adjustments required for taxable years beginning on or after the changeover date and before the 1956 adjustment date.* The application of this section may be illustrated by the following example, which is based upon the assumption that multiple asset accounts are used:

Example. (1) The facts are assumed to be the same as those in the example under paragraph (e) of § 1.9001–2, except that the adjusted basis of retirement-straight line property is determined as of January 1, 1955, and the depreciation allowable under the terms-letter from the changeover date to December 31, 1954, is $2,100.

(2) The adjusted basis on January 1, 1955, of the retirement-straight line property held by the taxpayer on that date is $4,195, determined as follows and in accordance with this section:

(i) Asset account:		
Unadjusted cost on January 1, 1943		$10,000
Less:		
Adjustment for abnormal retirement	$1,500	
Adjustment for normal retirement	1,000	
		2,500
Balance as of January 1, 1955		7,500
(ii) Credits to reserve for depreciation:		
Entire terms-letter reserve as of January 1, 1943		$3,000
Depreciation allowable under terms-letter from January 1, 1943, to December 31, 1954		2,100
Total credits		5,100
(iii) Charges to reserve for depreciation:		
Part of terms-letter reserve applicable to property abnormally retired on December 31, 1954		$450
Depreciation applicable to property abnormally retired and allowable from January 1, 1943, to December 31, 1954		345
Adjustment for normal retirement		1,000
Total charges		1,795
(iv) Balance in reserve for depreciation:		
Total credits		$5,100
Total charges		1,795
Balance as of January 1, 1955		3,305
(v) Adjusted basis of property:		
Balance in asset account		$7,500
Balance in reserve for depreciation		3,305
Adjusted basis as of January 1, 1955		4,195

§ 1.9001–4 Adjustments required in computing excess-profits credit.

(a) *In general.* Subsection (f) of the Act provides adjustments required to be made in computing the excess-profits credit for any taxable year under the Excess Profits Tax Act of 1940 (54 Stat. 975) or under the Excess Profits Tax Act of 1950 (64 Stat. 1137). These adjustments are set forth in paragraphs (b) and (c) of this section, and they shall apply notwithstanding the terms-letter.

(b) *Equity invested capital.* (1) Pursuant to subsection (f)(1) of the Act, in determining equity invested capital for any day of any taxable year under section 458 (relating to the Excess Profits Tax Act of 1950) or section 718 (relating to the Excess Profits Tax Act of 1940) of the Internal Revenue Code of 1939, the accumulated earnings and profits as of the changeover date, and as of the beginning of each taxable year thereafter, shall be reduced by the depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was held on the changeover date by the taxpayer or a predecessor.

(2) For the computation of accumulated earnings and profits in determining equity invested capital, see 26 CFR (1941 Supp.) 30.718–2, as amended by Treasury Decision 5299, approved October 1, 1943, 8 F.R. 13451, C.B. 1943, 747 (Regulations 109); 26 CFR (1943 Cum. Supp.) 35.718–2 (Regulations 112); and 26 CFR (1939) 41.458–4 (Regulations 130).

(c) *Equity capital.* (1) Pursuant to subsection (f)(2) of the Act, in determining the adjusted basis of assets for the purpose of computing equity capital for any day under section 437(c) (re-

lating to the Excess Profits Tax Act of 1950) of the Internal Revenue Code of 1939, the basis of the assets which enter into the computation shall also be reduced by—

(i) Depreciation sustained before March 1, 1913, on all retirement-straight line property held on March 1, 1913, by the taxpayer or a predecessor for which cost was or is claimed as basis and which was—

(*a*) Retired before the changeover date by the taxpayer or a predecessor, or

(*b*) Held on the changeover date by the taxpayer or a predecessor and also held as of the beginning of the day for which the equity capital is being determined; and

(ii) All depreciation applicable to the assets which enter into the computation and allowable under the terms-letter for all periods on and after the changeover date and before the taxable year for which the excess-profits credit is being computed.

(2) The adjustment required to be made by subparagraph (1) (i) (*a*) of this paragraph as of the beginning of the day for which the equity capital is being determined shall be made in accordance with the conditions and limitation described in paragraph (b) (2) of § 1.9001–2.

(3) For the determination of equity capital under section 437(c) of the Internal Revenue Code of 1939, see 26 CFR (1939) 40.437–5 (Regulations 130).

MISCELLANEOUS PROVISIONS

§ 1.9100–1 Extension of time for making certain elections.

(a) *In general.* The Commissioner in his discretion may, upon good cause shown, grant a reasonable extension of the time fixed by the regulations in this chapter for the making of an election or application for relief in respect of tax under subtitle A of the Code provided—

(1) The time for making such election or application is not expressly prescribed by law;

(2) Request for the extension is filed with the Commissioner before the time fixed for making such election or application, or within such time thereafter as the Commissioner may consider reasonable under the circumstances; and

(3) It is shown to the satisfaction of the Commissioner that the granting of the extension will not jeopardize the interests of the Government.

(b) *Exceptions.* Notwithstanding the provisions of paragraph (a) of this section, the time fixed by the regulations in this chapter will not be extended in cases such as the following:

(1) An election required to be made in or with the taxpayer's original income tax return;

(2) An election required to be exercised by the filing of a claim for credit or refund, unless the election is required to be exercised on or before a date which precedes the date of expiration of the period of limitations provided in section 6511;

(3) An election required to be filed in a petition to the Tax Court;

(4) An application for permission to change a previous election;

(5) An application for permission to change an accounting method as described in §§ 1.77–1 and 1.446–1;

(6) An application for permission to change an accounting period as described in § 1.442–1; or

(7) An application for permission to change the method of treating bad debts as described in § 1.166–1.

DANA LATHAM,
Commissioner of Internal Revenue.

Approved: November 9, 1960.

DAVID A. LINDSAY,
Acting Secretary of the Treasury.

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